1985

Bank of Montreal

168th Annual Report

(cover)

Winnipeg main branch at Portage and Main was completed in 1913 and has since been extensively renovated and restored; it is one of Western Canada's architectural landmarks. In front of the branch stands "Patria", a bronze statue of a Canadian soldier erected to the memory of Bank staff who fell in the Great War. The adjacent 24-storey Bank of Montreal building, completed in 1984, houses headquarters for Commercial and Domestic Banking operations in Manitoba and northwest Ontario along with two Commercial Banking Units and a Corporate Banking office.

Table of Contents

The Year's Highlights

For the Year Ended October 31

($ in millions except per common share amounts)	1984	1985	Increase (Decrease) %
Earnings Information			
Net income—reported basis	$ 283	$ 339	20
—loan loss experience basis	289	391	35
Dividends			
Common shares	135	149	10
Preferred shares	53	57	9
Shareholder Reinvestment Plans	128	172	34
Balance Sheet Information			
Total assets	$76,491	$82,420	8
Liquid assets	18,273	19,334	6
Loans (net of loan reserves)	47,929	51,966	8
Loan reserves	1,096	1,266	16
Deposits	66,671	71,388	7
Capital and contingency reserves	2,946	3,452	17
Common Share Information			
Number of common shares	70,497,599	77,425,769	10
Number of common shareholders	98,280	99,065	1
Net income per common share			
Basic	$ 3.37	$ 3.75	11
Fully diluted	3.30	3.64	10
Dividends declared per common share	1.96	1.96	—
Book value	31.51	33.77	7
Other Information			
Number of branches	1,222	1,220	—
Number of employees	33,598	33,281	(1)

The Chairman's Letter to Shareholders

Banking came under greater scrutiny in 1985 than at any time in memory.

The attention may not have been welcomed in all quarters, but if the result is a greater appreciation of some of the realities of modern-day banking, then it may turn out to have been a blessing in disguise. A number of remarkably enduring myths surround the banking industry which day by day become further removed from reality.

One myth holds that we are big and therefore bad. A more realistic view would be that the security and stability which size can bring are based on our traditional and continuing service to the smallest as well as the largest customers. Because our deposit base is broad, and our customer base is broader, we are captive to no one. The security of the funds of the smallest depositor is not a hostage to the decision of one or a handful of large depositors who, for whatever reason, decide to change their bank. Nor are we dependent upon a single market or beholden to a dominant ownership interest. Nowhere more than in our industry is there truth to the old saw that there is security in numbers.

In this day and age, however, large numbers—whether of customers or transactions—require automation. Automation is necessary not only to maintain an efficient operation, capable of providing service of acceptable quality at a reasonable cost, but it is also essential to maintain adequate control. The sheer volume of transactions makes manual systems not only relatively expensive and error-prone but deficient in satisfying internal control requirements for timely and accurate information. Unfortunately, automation is expensive and banking as we know it has become a capital intensive industry. As in other industries with similar characteristics, only large firms can mobilize the necessary investment.

This is not to say that there is no place for small banks. There is. But, they must consider very carefully where their true role lies and manage their affairs to take account of their particular strengths and limitations.

Another myth holds that we are immune to competition. Thus, we are said to represent unchecked power in a democratic society that distrusts all power, whether exercised by government, labour, the media or any particular industry.

If ever the power of the banking industry was unchecked, it was in another age, not the present one and, most certainly, it will not be in the age of banking that is dawning.

Discerning observers are seeing the reality of competitive banking, not the myth of unchecked power.

What are the sources of this myth? I think it is partly a result of the success of the Canadian banking system, which has a history of extraordinary stability and service. This Bank, for instance, has an unbroken record of service for 168 years, longer than the life of most countries. Perhaps some Canadians have assumed that Canadian banks stop at the border, and that the competition within Canada's borders is insufficient to check the power of banks. Once, possibly, that might have been so, but no longer.

Our business, of course, does not stop at the border. We cannot, because Canada's national livelihood depends upon buying, selling, trading and investing on a worldwide basis. By the same token, however, the banks of other nations, to serve their customers, must be able to serve them in Canada. There is an element of enlightened self-interest in this as well as that of simple fair play. No nation, however, Canada included, can afford to allow its national banking system to become so weakened that it becomes dependent upon foreign banks in any essential respect.

As trade talks get underway with the United States, financial services will doubtless be on the agenda. Any proposals for "reform" of the domestic financial services sector, of which banking is the key industry, should be carefully examined lest the result be the weakening of one Canadian industry which is strongly competitive, both at home and abroad.

The competitive field on which Canadian banks must play is the international financial system. The competitive game is fierce, seldom fiercer than since the recession of 1981-82. In this global competition lies another check on the power of this industry.

Myth holds, as well, that despite the toughness of international competition, we are protected within Canada from that competition. The reality is that in this decade, only half over, some 57 foreign banks, a number of them larger than the largest Canadian banks, have established subsidiaries in Canada. What are they but competitors, here and abroad?

The competitive capacities of non-bank financial institutions in Canada are also rather underestimated, perhaps because perception has not caught up to the reality. Some of these organizations would, in fact, rank amongst the largest financial institutions in the country. They take deposits, they make loans and they participate in the payments system. For the most part, however, they are neither subject to the same constraints as banks nor burdened with the same costs. To pretend they are not in competition with banks is to ignore reality.

What the future holds is still tougher competition, not easier, and it will be conducted in tougher circumstances, shaped by the interaction of broader economic, social and political forces.

As 1985 ended, these forces were forming a pattern different from that of earlier years. If one cannot predict precisely what the pattern eventually will be, one can see nonetheless that it will generate entirely new competitive pressures on every institution but especially on banks.

We are now beginning the fourth year of economic recovery. There is much in the recovery that is healthy and positive, including the absence of signs of overheating or cost pressures that could end this period of growth.

Nonetheless, there are a number of signs of fundamental disequilibrium, all of which shape the international competitive environment within which we must operate. Unemployment remains far too high, a clear sign of under-utilized capacity, a source of human suffering and a generator of political pressures on governments everywhere. Real interest rates are too high, which discourages the investment needed to reduce unemployment. Currencies remain misaligned with powerful distorting effects on trade and capital flows. One result has been the intensification of protectionism, particularly in the United States. At the root, both a sign of disequilibrium and a cause, lie continuing high government deficits.

Most troubling, the fastest growing component of deficits is now the cost of servicing the debt spawned by past deficits—old debt has become a principal source of new debt, a classic vicious circle that must be broken if economic equilibrium is to be restored and sustained world economic growth is to be achieved.

Whether this vicious circle is broken by coordinated, deliberate action or left to be resolved by less controlled means, the fact of economic disequilibrium will shape the challenges, risks and opportunities, and the nature and intensity of international competition in the coming years.

To this must be added the changes that are taking place in international competition, not as a result of changes in technology or economic circumstances, but through the deliberate actions of governments.

The various regulatory proposals before Canadians—and those to come—are matched abroad. To the list of "revolutions" besetting the world, we must add the regulatory revolution, of which Canada is a part. The U.S., the U.K., Australian, Japanese and New Zealand financial sectors, among others, are undergoing profound change, in terms of the nature of competition within those markets and in the degree of foreign participation.

Thus, the competition is shifting before the combined effects of technology, economic pressure and regulatory change.

But there is a deeper reality. Not only are we not protected from international competition, but there can be no protection. So long as we live in a democratic society where people are free to spend or invest their money where they will, either at home or abroad, then banks and other financial institutions will have to be the freest of traders. The only effective impediments to the free flow of financial services in such circumstances are the unwillingness of people to move their funds, for whatever reason, and the lack of technology to allow that to happen quickly, efficiently and safely. Technological change is removing the remaining impediments at a startling rate.

Governments have been somewhat slow not only to grasp fully the implications of these changes for the financial system but also for the conduct of public affairs. Increasingly, the markets' judgment of the conduct of monetary and fiscal policy will be reflected in the movement of funds, the levels of exchange rates and, ultimately, in trade flows and associated employment. In the long run, the choice will be between responsible, disciplined fiscal management or ever-increasing efforts by governments to control trade and investment. The latter would be not only fiscally futile, but would threaten, more effectively than any hostile political philosophy, the democratic form of government.

How have we fared in this environment? So far, this Bank has fared reasonably well. The Bank itself, in the last few years, has undergone tremendous change, sometimes smoothly, sometimes not so smoothly. For most of this period, it has had to cope with an external environment marked by a high degree of instability. During the recent recession, it absorbed losses of a magnitude not seen since the Great Depression.

Nevertheless, a major restructuring has been carried through to conclusion, the Bank's physical plant has been substantially upgraded, an ambitious program of automation has been carried out, staff training has been expanded several times over and its quality markedly improved, and a major acquisition has been consummated in the United States. This agenda is far beyond what anyone imagined was possible a few years ago and reflects great credit upon the staff of the Bank.

Notwithstanding the immense commitment of resources which has been required, the Bank's capital has increased several fold, its capital ratio is at the highest level since 1971, reserves for losses are now greater than the entire capital of the Bank only six years ago, and liquidity is at a level unprecedented in recent times.

What are tomorrow's priorities?

Internal control has become an issue in banking worldwide. It is integral to the prudent management of risk as well as to accurate reporting. Volatile markets, economic instability, rapid technological change, inflation, the two oil shocks, the recession, "de-regulation" and so on have placed an enormous load upon the control systems of most banks. In our case, the first visible evidence of inadequacies in this area came to light in the early 1970s. Corrective efforts revealed that the foundations were weak and unable to support adequate management and internal control systems. To redress this deficiency has required several years and the commitment of substantial resources. It is now largely accomplished, and the work of implementing advanced reporting and control systems is progressing well, as mentioned elsewhere in this report.

For the foreseeable future, internal control will continue to be a high priority in the Bank. Considerable attention will be given to refining our techniques to achieve an optimal balance between internal control and the appropriate degree of local authority and initiative, so necessary to good customer service.

This year, for the first time, the Report to Shareholders contains a section on "Risk Management and Control" which outlines, within the limitations of available space, some of the principal risks involved in our business and how we approach their management and control. We are also taking a number of steps to involve the Board of Directors, individually and collectively, more fully in these issues. Not only is it the duty of a director to inform himself adequately as to the affairs and condition of the Bank, but also the heavy responsibility which devolves upon a director leaves him no choice but to discharge this duty as diligently as possible. To encourage and facilitate the assimilation of information by the directors so that the Board can exercise informed and prudent judgment is an important duty of management.

Clearly, the automation program, now so far advanced, should be completed. It is encouraging to realize that we have come much further than the distance we have left to go, and overcome greater difficulties than we expect to encounter in completing this program. Completion is, of course, a relative concept. Systems require more or less constant maintenance to keep them efficient and to accommodate change. Nevertheless, emphasis is now shifting from processing transactions to information. As this phase matures, the full benefits from this investment will begin to be realized.

The Harris acquisition has proceeded smoothly and is living up to our expectations. Its financial impact should be digested in another year or so. Since it is not intended to integrate management, the emphasis will be upon defining the respective organizational roles and markets, establishing goals, and building the spirit and habit of teamwork upon which an effective and well-coordinated overall performance depends. In this way, we expect to maximize the potential inherent in this strategic association.

Within the parent Bank, the respective banking groups need to concentrate upon fine-tuning their organizations and bringing each of their components up to a satisfactory level of performance. As yet, the desired consistency of performance has still to be achieved.

While great progress has been made in skill training within the Bank, more emphasis must be placed upon management training, specific to our principal areas of activity. This priority will relate closely to the increasing emphasis being placed upon information systems.

As the impracticality of attempting to be all things to all men becomes daily more apparent, the Bank will continue to sharpen its focus upon markets where the greatest potential lies and where it can mobilize its strengths most effectively. Other commitments will be gradually reduced, freeing resources for more productive employment. Readers will have noted that, while a number of overseas offices have been closed, others have been greatly enlarged to accommodate an increase in the resources committed to those markets.

Another such example is the capital markets area which is accorded a high priority for continued development and expansion. While good progress has been made to date, additional resources will be committed to building the Bank's capacity to serve its clients in these markets.

Finally, the highest priority is to improve the profitability of the Bank without compromising our emphasis upon quality. As the pressures generated by the rebuilding phase ease and as we learn to operate the sophisticated and sensitive machine which is today's Bank of Montreal, this is a realistic objective. Its realization will doubtless be warmly welcomed by our fellow shareholders.

Board of Directors

This year, we mark the retirement from the Board of four valued colleagues: Charles R. Bronfman, O.C., a director since 1966; Nathanael V. Davis, D.Sc., a director since 1961; A. John Ellis, O.C., a director since 1973; and Jack H. Warren, O.C., a director since 1979. Over the years, they have brought to the Bank the benefit of their extensive knowledge of business, management, government and public service. With them, as they leave our councils, go not only our warmest good wishes but also our gratitude for their considerable contributions to the Bank.

Your Board is recommending the election of two new directors, Mary Alice Stuart, Chairman of CJRT-FM Inc., Toronto's public broadcasting station, and Ralph M. Barford, President of Valleydene Corporation Ltd. This will bring the number of directors to 39, down from 54 a few years ago. The responsibility of directors is a heavy one and it is important that the Board be of a size to enable it to perform its role effectively.

During the year, the Board of Directors approved in principle a recommendation of its Executive Committee in respect of Board committees. Under this proposal, the responsibilities of the Management Resources and Compensation Committee would be assumed by the Executive Committee, with compensation matters to be dealt with by a sub-committee of non-officer directors. A new committee, Risk Review, would be appointed with responsibility for reviewing at regular intervals, with the appropriate officers of the Bank, (i) the major risk areas integral to the operations of the Bank, (ii) the degree of risk normally assumed by the Bank, (iii) the management and control of risks and (iv) the reporting on these matters to the Board of Directors.

It is expected that this recommendation will be presented for implementation to the incoming Board following the Annual General Meeting.

William D. Mulholland
Chairman and
Chief Executive Officer

Report from the President

During 1985, the Bank emphasized two primary and closely related objectives. While reinforcing present performance, the Bank also sought to enhance the quality of resources on which future profit, soundness and security depend—people, technology, capital, organization and controls.

For the Bank as a whole, reported earnings totalled $339 million, some 20 percent higher than in 1984. Comparison of this year's income statement with last year's is complicated by the inclusion of the results for Harris Bankcorp for the full fiscal year in 1985 and for only the two months following its acquisition in 1984.

The performance of all major banking groups improved relative to 1984. The biggest gains occurred in the Treasury and Commercial Banking Groups.

Under present regulations, reported earnings include a provision for loan losses based on a five-year moving average formula. This totalled $428 million, an increase of $53 million. Actual loan losses in 1985, at $330 million, fell by $35 million for the Bank as a whole, and $73 million for the Bank excluding Harris.

A clearer picture of the Bank's *current* earnings performance can be gained by substituting the *actual* loan loss experience in 1985 in place of the provision for loan losses. Based upon the *actual* loan loss experience, the Bank's *current* earnings totalled $391 million—$102 million or 35 percent higher than in 1984.

The substantial improvement in our earnings performance came from a number of sources. Net interest income increased 21 percent, about half of which reflects the inclusion of Harris for a full year. The remainder is attributable to several factors: in particular, growth in earning assets, an improved spread on international money market operations and increased margins on security holdings. These were offset, to some degree, by a narrowing of margins between the cost of retail deposits and Canadian lending rates.

Other operating revenue was up $182.7 million. Excluding Harris and non-recurring gains realized in 1984, the increase was 9 percent in fiscal 1985. Major contributions came from foreign exchange dealing and MasterCard. As for non-interest expenses, continuing emphasis upon productivity improvement and cost control limited the annual increase in these costs to 3.7 percent in the Bank, excluding Harris.

Total consolidated assets at October 31, 1985 were $82.4 billion, an increase of $5.9 billion from a year earlier. Over the year, the loan portfolio grew by $4 billion to $52 billion.

Harris Bankcorp had an excellent year. Over 1985, Harris and the parent Bank continued to harmonize their activities effectively. The natural synergies between the two are increasingly evident in both organizations' improved performance. Together Bank of Montreal and Harris remain the only bank group with complete operating capability in both Canada and the United States.

The acquisition of Harris and the steps completed last year to realign the Bank's operating groups to match our major markets have greatly strengthened not only our earnings performance but also our ability to serve our customers better whenever and wherever they deal with the Bank. Because of a sharper focus on our markets and a greater concentration of expertise, it has been possible to develop closer banking relationships with our commercial customers. The same factors have facilitated the development of new, more sophisticated banking services and the improvement of existing services. One noteworthy illustration of this is the development of a Canada-United States cash management service—the only transborder service of this kind available in the market.

The organizational changes undertaken in recent years have also streamlined procedures, strengthened controls and focused resources on those activities that are most productive. One example is the steps taken to decentralize marketing and customer-related activities while at the same time improving lending standards, reviews and controls. This has resulted in both lower loan losses and improved customer service. Another example is the specialized banking units set up to deal with customers in financial difficulty.

Banking is a service industry. The key to success is providing high quality service in all its forms. Today, the Bank has in place the people, technology and organization to meet its commitment to its customers and the market.

During 1985, the Bank's capital base increased by over $500 million. At year-end, equity capital and reserves (excluding loan loss reserves) totalled $3.5 billion. Capital and reserves were 4.19 percent of assets—a record high and well above the level of 3.85 percent at the end of fiscal 1984. At the same time, the Bank's liquid assets, including cash, deposits with the Bank of Canada, deposits with other banks and liquid securities such as Government of Canada Treasury bills, totalled $19.3 billion—equal to 27 percent of total deposits. Personal deposits, which constitute a dependable funding base, made up 72 percent of the Bank's domestic deposit base.

As evidenced by the improvement in loan losses, the quality of the Bank's assets has improved substantially. In 1985, loan loss experience amounted to 0.58 percent of total eligible loans, down from 0.68 percent (restated to reflect the full year loss experience for Harris Bankcorp). Non-current loans declined to $1.3 billion, down $256 million. By the end of fiscal 1985, total specific and general reservations against all loans in the 32 countries specified by the Inspector General of Banks were 10 percent of the total amount outstanding. No difficulty is foreseen in meeting the Inspector General's guideline.

Ultimately, the Bank's most important resource is people. In October 1985, the Bank's complement was 33,281, including some 4,700 Harris employees. In 1985, the Bank invested in over 100,000 man-days of training for its staff—approximately 90 percent more than in 1984 and nearly triple the amount in 1983. Along with training, the Bank's personnel policies have been further refined in order to provide greater opportunity and incentive to help each employee to do a better job and make the most of his or her potential. The improvement in the Bank's performance in 1985 provides evidence of the motivation, ability and management skills of the people in the Bank.

Heavy investment also continues to be made in another key resource—technology and systems. Among the notable achievements in 1985, described in the following pages, are a transborder electronic payment system for corporate customers, the successful implementation of an integrated financial system that processes more than 300,000 general ledger entries every working day, an automated international transaction processing system, an improved management information system, the first phase of a comprehensive customer and product information system and facilities to provide a wide range of flexible mortgage options to our customers.

Perhaps the year's most striking advance has been in expanding the access afforded the Bank's retail customers to their accounts via statement printers and automated banking machines. In addition to expanding its own network of these machines, the Bank joined with the CIRRUS automated banking machine network in the United States. It also sponsored the Circuit network in Canada, which became operational in 1985 and includes a group of non-bank financial institutions. In addition, the Bank is a founding member of the Interac network in Canada, which is expected to become operational in 1986. By the end of 1985, the Bank had provided its customers with access to over 10,000 automated banking machines in North America. By the end of 1986, as Interac becomes operational, this network will be extended by an additional 2,000 machines in Canada.

All in all, 1985 was a good year for the Bank. The challenge now is to build upon the momentum that has become apparent and to take full advantage of our strength in the marketplace.

G.L. Reuber
President and Chief Operating Officer

Profile: The Bank's Business

Bank of Montreal operates worldwide from a broad customer base in Canada reinforced by a strong United States presence.

The banking groups that serve the Bank's domestic and international markets are described below, together with a summary of the Bank's financial position.

Bank Groups

Within Canada, the *Domestic Banking* Group is responsible for all personal banking services. It operates a system of some 1,180 branches, supported by a nationwide network of some 6,000 on-line real time teller terminals, in addition to nearly 400 other customer service facilities. This branch system is the historic source of the Bank's strength. It provides the Bank with a diverse and stable source of funds and its customers with a range of the most modern banking services available, including a secure depository for their funds at a competitive return.

In some parts of Canada, Bank of Montreal branches provide the only banking services to smaller communities.

Increasingly, the Bank has sought to reinforce the branch system as technology has opened new possibilities for providing customers with better service and access. The Bank has developed a network of its own automated banking machines (ABMs) and is further extending customer access through ABMs by sharing arrangements with other financial institutions in Canada and the United States.

Further extension of customer access to banking services is being developed through installation of terminals in retail stores to make shopping more convenient.

Domestic Banking is also responsible for the management of the operational infrastructure in Canada which supports the transaction requirements of personal and business customers.

Staff of the *Commercial Banking* Group, based in units strategically located across Canada, provide banking services to independent, mid-size and agri-business enterprises.

The *Corporate and Government Banking* Group serves governments, financial institutions and multinational and national corporations in Canada and abroad. In the United States, market responsibility for major national corporate relationships is shared with the Bank's subsidiary, Harris Bankcorp, Inc.

The *Treasury* Group delivers money market, foreign exchange, securities and advanced financial risk management services. It assists the other line groups and maintains contact with customers who require direct access to the financial markets. Treasury also manages the Bank's international branch network.

Supporting these activities is the *Operations and Systems* Group. It has made possible streamlined domestic operations; new customer services; transaction automation for Treasury operations; retail, commercial and international electronic funds transfer and cash management services; and new information systems for financial and human resources management.

Bank Assets

Year-end consolidated assets totalled \$82.4 billion. Cash and other liquid assets were \$19.3 billion. Commercial advances, including bankers' acceptances and loan substitution securities, amounted to \$46.2 billion. Advances to personal customers totalled \$13.1 billion. Reservations set aside for possible loan losses amounted to \$1.3 billion at year-end.

Some 77.5 percent of the Bank's consolidated assets were centred in Canada and the United States, while Western Europe accounted for 9.0 percent and Asia and the Pacific Basin 6.3 percent. These areas contain the markets in which the Bank is focusing most of its efforts.

Assets in Latin America and the Caribbean amounted to 6.6 percent of the total. The proportion of Bank assets in other regions—Eastern Europe, the Middle East and Africa—represented less than 1.0 percent of the total.

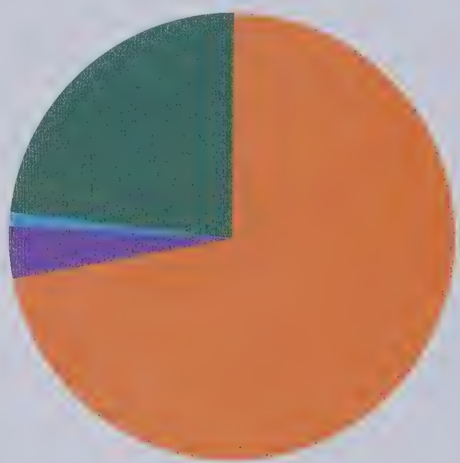
Bank Deposits

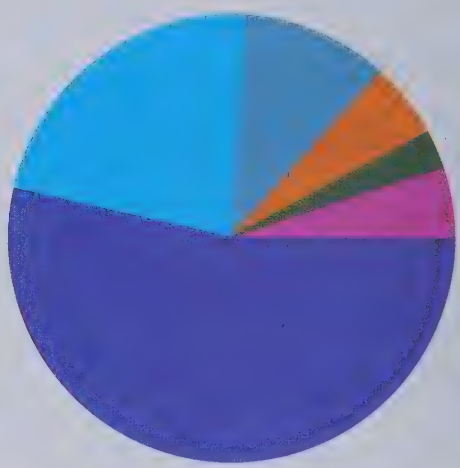
Deposits totalled \$71.4 billion. Demand deposits were \$8.9 billion, notice deposits \$18.5 billion and fixed term deposits \$44.0 billion. Diversification of funding sources, like asset diversification, is an important objective in the management of the Bank's operations.

Capital

At fiscal year-end, equity capital of the Bank stood at \$3.5 billion, an increase of \$507 million since last year. The expansion of the Bank's capital base in 1985 came primarily from retained earnings, proceeds from shareholder reinvestment plans and the amount by which charges to income in respect of loan losses exceeded the actual loan loss experience for the year.

Business Profile
($ in millions)

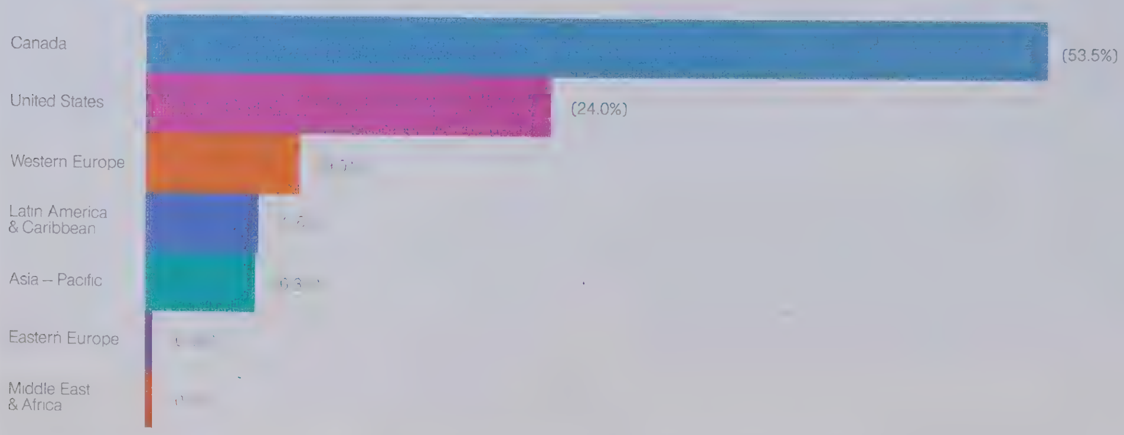




Use of Funds	1985
Credit Operations	$59,338
Liquid Assets	19,334
Investments	783
Other Assets	2,965
Total Use of Funds	$82,420

Source of Funds	1985
Demand Deposits	$ 8,867
Notice Deposits	18,553
Fixed Deposits	43,968
Acceptances	4,228
Other Liabilities	2,252
Capital Funds	4,552
Total Source of Funds	$82,420

Distribution of Assets By Location of Ultimate Risk
% of total assets as at September 30, 1985



Banking Services

Personal Banking

More than four million Canadians—one quarter of the adult population—have personal accounts with Bank of Montreal.

Deposits

The Bank's deposit services provide customers with secure custody of their funds and unsurpassed transactional facilities. Deposits by individuals account for 72 percent of total Canadian dollar deposits.

Maintaining this broad base has required meeting demands for the highest quality service and modern banking products. The Bank's response was reflected in the popular Chequable Daily Interest Account and its successor, Investment Chequing,™ which was introduced in November 1985. This new account combines the best features of Chequing, Daily Interest Savings and short term deposit accounts. It permits unlimited free chequing, with a minimum monthly balance, and pays the same interest rate as a savings account or a short term deposit on daily balances above the set minimum.

In addition to the Bank's own deposit instruments, Bank of Montreal Mortgage Corporation issues Investment Certificates. Longer term six and seven year certificates were added in 1985. A new Registered Retirement Income Fund option based on Investment Certificates provides customers with an alternative to annuities.

Loans

Advances to personal customers, including mortgages, provided 20.5 percent of the Bank's total credit portfolio in 1985. These balances increased by 6.2 percent over the previous year. Personal Line of Credit showed the largest percentage increase among personal lending categories, closely followed by residential mortgages. Consumers have used their credit in a responsible manner; in relation to disposable income, consumer credit outstanding is well below the record high established in 1979.

Bank of Montreal has been a leader in responding to customer needs in the mortgage field; during the year, we introduced a variable rate, a pre-approved and a portable mortgage; a mortgage rate protection plan; a six-month open mortgage; and a weekly payment option. The Bank is the only lender to offer a seven year term option. The range of features and options now provided by the Bank offers the customer greater control and flexibility in an area which, for many, represents the largest and most important lifetime investment. The Bank's low transfer fee is designed to make it easier for home owners to transfer their mortgages in order to avail themselves of the broad range of options offered by the Bank.

Bank of Montreal Mortgage Corporation holds virtually all residential, home equity collateral, agricultural and commercial mortgage loans made through Bank of Montreal. The total mortgage portfolio of the Corporation rose to $7.2 billion in 1985.

Customer Service

In April 1985, the Bank announced a major customer service improvement program entitled "Doing More for You is What Sets Us Apart". This has been very successful. Customer surveys, which are undertaken at regular intervals, show that more than 95 percent of personal customers surveyed rate Bank service as "excellent" or "good".

The Bank has introduced new services over the past few years for customers with more complex personal financial needs. The Private Banking™ Centres, which are especially designed to serve this group of clients, provide a wide range of these services.

InfoService® – a nationwide network of centres staffed with banking information specialists—provides an additional convenient contact point for our customers. It is unique in the industry. Requests for information regarding Bank services and locations account for some 95 percent of customer inquiries. In 1985, InfoService helped some 450,000 customers, and its popularity is growing.

Customer Convenience

A network of some 1,180 branches provides access to our services in virtually every community in Canada. Extended hours of service have been implemented in over 90 percent of branches. Saturday openings have been increased. In-branch service improvements such as Quick Cash, Quick Deposit, Mini-Cheque Desks and Time Saver application forms are designed to shorten customer waiting time.

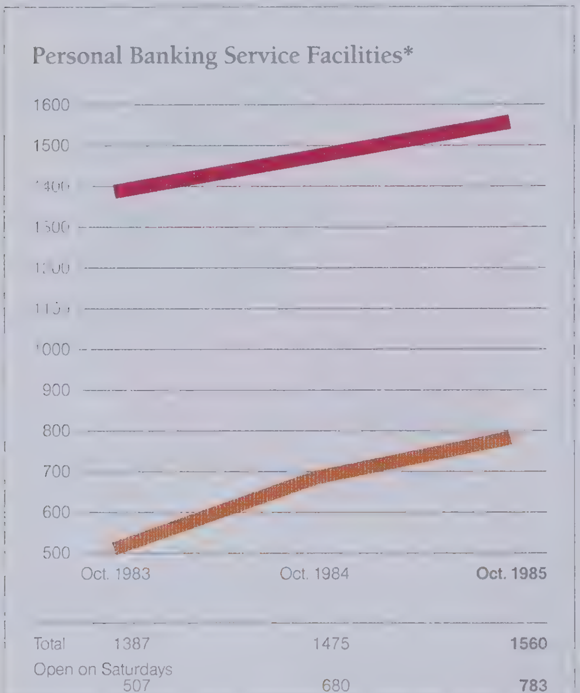
Without minimizing the Bank's traditional emphasis on the importance of personal contact in customer service, a major effort is under way to make available to customers a range of easy-to-use facilities which significantly extend service beyond the limitations of branch hours or location. Included in the expanding array of new convenience facilities are the Bank of Montreal Instabank® and the Circuit™ ABM networks in Canada; the CIRRUS® ABM network in the United States; MoneyTrac statement printers; Multi-Branch

™-Trade Mark of Bank of Montreal
®-Registered Trade Mark of Bank of Montreal

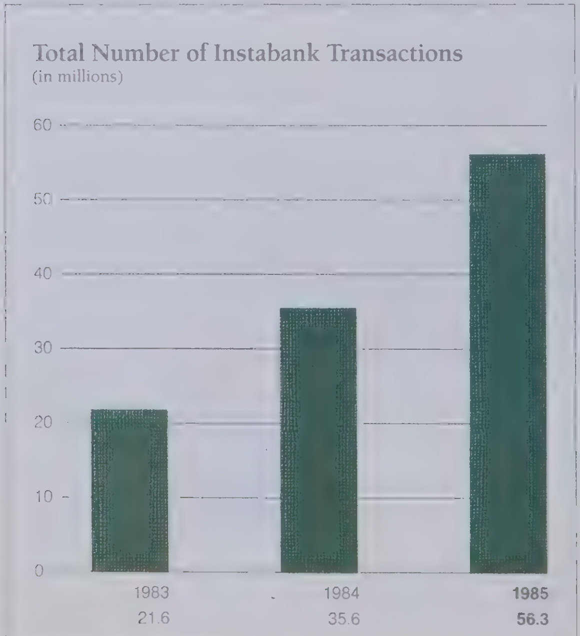
®-Registered Trade Mark of CIRRUS System Inc
Bank of Montreal is a registered user

Banking® card services; and MasterCard® services. The expansion in the number and variety of such services is made possible by the Bank's advanced technology.

For Bank of Montreal account holders, Instabank ABMs provide cash disbursement, payment, money transfer and information services—simply and efficiently, seven days a week. The Money Mobilizer™ feature, unique to the Bank's technology, permits customer access to as many as 10 different accounts which may, at the customer's preference, be in several different branches located anywhere in Canada. In 1985, customer usage surpassed five million ABM transactions a month.



*A service facility is a branch or an Automated Banking Machine site which is accessible outside regular banking hours



MoneyTrac™

A new service was launched in late 1985 entitled MoneyTrac. It is a major enhancement to the array of information services available to customers. A machine, which is activated by a MasterCard or Multi-Branch Banking card, enables customers to obtain, instantly, a printed statement of any personal deposit account held with the Bank at any time during the month and as often as the customer wishes. It has great appeal to customers who have an immediate need to see the status of the account and the list of entries since the last time a statement was received. This service, when combined with the Money Mobilizer feature of Instabank ABMs, provides a unique capability for personal cash management and budgeting.

ABM Sharing

In 1985, Bank of Montreal was the first Canadian financial institution to inaugurate a multilateral Canadian ABM shared network. As a result, Bank of Montreal customers are the first in Canada to benefit from this technological development. A number of other financial institutions have already joined the Bank's system, called Circuit, which is now operational.

Holders of encoded MasterCard or Multi-Branch Banking cards issued by Bank of Montreal will soon have access to ABMs located in retail and convenience stores. During the year, the Bank also became a founding member of Interac, a multi-bank network of ABMs planned for introduction next year.

In recognition of the fact that Canadians travel extensively, the Bank undertook a further initiative in 1985 to extend the ABM cash disbursement convenience available in Canada to customers travelling to the United States. This initiative culminated in the Bank going live with the link to CIRRUS, the largest ABM network in the United States, on July 15. Bank customers with encoded MasterCard or Multi-Branch Banking cards can use more than 10,000 ABMs in 47 of the 50 states. Bank customers in the United States with CIRRUS cards can use Bank of Montreal Instabank ABMs in Canada. The Bank was the first Canadian financial institution to implement such a cross-border link, and currently provides customers in both countries with access to the largest automated banking system in North America. For travellers to the United States, a toll-free number (1-800-4-CIRRUS) provides information about machine locations.

Direct links through point-of-sale terminals provide automatic credit card authorizations for Bank customers at major retail chains. This system will be extended to smaller merchants, initially in Montreal, Toronto and Vancouver, leading to increased demand for cash management services from merchants and the further development of debit card services.

®-Registered Trade Mark of MasterCard International
Bank of Montreal is a registered user
™-Trade Mark of Bank of Montreal

The combination of these major initiatives successfully implemented in 1985 provides our customers with banking access second to none and ensures that they and the Bank will benefit fully from the evolution of electronic payment systems in Canada.

MasterCard Services

In 1985, the Bank's card services recorded significant growth in assets, number of cardholders, transaction volume and merchant coverage.

A major program was launched in 1985 to expand the number of MasterCard cardholder accounts. This campaign has been very successful and will continue into 1986.

Bank of Montreal's No-Fee MasterCard represents a vigorous competitive force in the charge card field as its success in attracting new cardholders, and in increasing the dollar volume of retail purchases made on the card, demonstrates. It offers a distinctive feature which the public obviously values.

Merchant coverage was significantly enhanced in 1985 by the addition of the Eaton and Woodward department store chains and Southland Canada (approximately 400 7-Eleven convenience stores) to the already extensive network of merchant outlets accepting the card.

Gold MasterCard

Gold MasterCard combines a prestige credit card, a preferred rate line of credit and an extensive package of banking services, all with the advantage of a single fee. It also has a deposit feature which permits it also to be used as a debit card. For clients who choose to use the Private Banking facilities, Gold MasterCard is included at no additional charge.

MasterCard Travellers Cheques

The MasterCard family of services was expanded in 1985 through the extension of MasterCard Travellers Cheques to all provinces. This was made possible by arrangements completed with MasterCard International and Thomas Cook Canada Ltd. These travellers cheques are accepted internationally and are refundable at over 110,000 offices around the world.

Small and Medium-Size Businesses

The Bank is strongly committed to meeting the banking needs of independent, mid-market and agricultural businesses in Canada. To provide a highly professional service to these important sectors of the economy, teams of qualified Commercial Banking officers, administered from approximately 100 specialized units across the country, represent the Bank from over 450 locations.

The past year has been marked by important improvements in quality of customer service. New and streamlined products have been introduced, and service standards raised and brought into sharper focus throughout the organization.

To improve speed of response on loan applications, increased credit approval limits have been delegated to Commercial Banking managers in communities across the country. Credit "turnaround" standards have been improved and are closely monitored. Intensive training of lending officers and continued emphasis on a rigorous loan review and audit process have accompanied, indeed made possible, this further decentralization of authority.

The vital day-to-day banking services provided by the domestic branch network to commercial customers, such as deposit, cash management and other non-credit services, also received priority attention during 1985. In particular, Domestic Banking and Commercial Banking Groups have implemented a carefully coordinated program to ensure that standards of performance in this important aspect of customer service reflect, on an on-going basis, the quality and timeliness of service required by clients.

While the Canadian marketplace for banking services to small and medium-sized businesses is diverse and widely spread, the Bank has organized its resources to cater in a specialized way to the needs of particular market segments. These include, among others, independent business, agriculture, local governments, automotive financing, retailing and real estate.

In 1985, a high priority for the Commercial Banking Group was to improve its service to the independent business market. Specialized account management teams have been created and dedicated to this market, and the Bank's product line simplified and streamlined. Central to this effort was the introduction of the FirstBank Operating Account™ combining the customer's borrowing and chequing accounts into a single operating account which can also earn interest on credit balances. The combination of initiatives in this area results in a new way of banking. It serves to provide customers with greater control of their cash resources and simpler administration.

An integral part of this streamlined approach is a simplified fee structure, producing a fixed monthly charge. This eliminates the need for customers to monitor and reconcile the numerous bookkeeping entries which had resulted from the previous method of charging on a transaction-by-transaction basis. The introduction of the FirstBank Operating Account, and the package of improvements outlined above, have been well received in the marketplace.

Canadian agriculture, an important sector for the Bank, faced more economic difficulties in 1985. The Bank continues to participate actively in resolving these problems, and to work closely with provincial and federal government agencies to coordinate support for farmers. In these and other efforts, the professional expertise of the Bank's regional agrologists and guidance from its Farm Advisory Panels have been invaluable. As well, the annual Agricultural Outlook conferences continue to be welcomed by the industry.

In 1985, the Bank launched a comprehensive automotive financing package. It provides dealers across the country with a specialized set of services to meet their particular financial needs and those of their auto-buying customers. Automotive Finance Centres, staffed by industry specialists, were opened in Halifax, Montreal, Toronto, Calgary, Edmonton and Vancouver, with additional centres to be opened in 1986.

Municipal and other local government accounts represent important relationships for the Bank. The Bank's initiatives in this market have concentrated on improved customer service through innovative lending products, such as fixed rate operating loans..

Other market developments during the past year include increased emphasis on the design of franchise financing packages; the establishment of specialized Real Estate units in Toronto and Montreal; and more focused and dedicated attention to our depositing customers on a nationwide basis. Indeed, deposits from Commercial Banking customers are a valued component of these relationships.

In 1985, some 16,000 clients of the Commercial Banking Group responded to surveys on service levels and product needs. The results of these surveys reflect an improving level of customer satisfaction, with four out of five clients indicating their positive reaction to the Bank's service.

New plans and programs are regularly presented to the Bank's Business Advisory Panels, made up of business people from a broad range of industries, to ensure that the market's needs are being met.

Special Banking Units across the country continued to work with commercial clients in difficult circumstances. By concentrating expertise in dealing with such customers, these units have achieved notable success in assisting companies to regain financial health.

The Bank also plays a role in supporting the development of new and smaller enterprises by making available its Small Business Problem Solver series of booklets and regularly published Independent Business Review. This material, which provides sound business operating and planning advice, has been widely circulated and used as regular reference material by businesses, accountants, consultants and educational institutions.

The past year has been marked by solid progress and improved profitability for the Commercial Banking Group. The quality of service to clients has been enhanced. In addition, the Group has developed the clear focus on the customer and the marketplace necessary for future success.

Governments and Financial Institutions

In October, the Bank was appointed a financial advisor to the Ministry of Water Resources and Electric Power of the People's Republic of China.

The agreement was the first of its kind between the Ministry and a foreign financial institution.

As financial advisor, the Bank will help structure financial packages using official and private sources of funds, and provide banking services as appropriate. It will also facilitate the supply from Canada of equipment, technology and services to the Ministry.

The Bank's long involvement with electric power development provides important support for China's ambitious plans for hydro-electric development. Several projects are being considered for participation by Canadian companies, as Canada is a leader in all aspects of power generation and transmission. Canadian firms offer unsurpassed experience not only in design and construction, but also in the manufacture of equipment used in such developments.

During the year, the Province of Manitoba and the Manitoba Energy Authority also chose the Bank as a financial advisor for the $2.1 billion Limestone hydro-electric project in northern Manitoba.

The Bank is a major dealer in Government of Canada and provincial government money market instruments.

In 1985, at the invitation of the Province of British Columbia, the Bank became the only commercial bank member of the underwriting group for the Province's short term marketable securities.

Maintaining a lead role with Canadian and foreign governments presents considerable challenges. Canadian government entities at all levels, and public sector borrowers in industrialized countries with good credit ratings, have direct access to international debt and capital markets. These borrowers' expertise in this field is also growing rapidly. While this may serve to reduce the need for traditional bank financing, it has expanded opportunities for Bank participation in underwriting, placement and trading of debt instruments and securities. The Bank's strong presence in major financial markets will support the extension of its services to public sector borrowers.

The relationship between the Bank's strong position in the Canadian market and its worldwide network is an important element in its service to correspondent banks abroad and, of course, to those with offices in Canada. The Canadian subsidiaries of foreign banks are customers for clearing services and related products, including operating credit lines and maintenance of reserves required under the Bank Act, cash management products and lines of credit for money market and foreign exchange operations.

The Bank also has developed close relationships with non-bank financial institutions such as trust companies, insurance companies, investment trusts, securities dealers and credit unions in Canada and abroad.

To meet their needs, the Bank delivers cash management services especially tailored to the requirements of such customers, based upon its advanced electronic systems infrastructure.

Specific products enable financial institutions and governments to accelerate cash inflows from widely dispersed areas, handle large volumes of cheques efficiently and obtain comprehensive, timely information on account status, securities positions and cash balances. Similar services have been developed to meet the special needs of institutional investors in Canada and abroad.

The new Transborder Electronic Payment Service™ allows governments, financial institutions and businesses which currently make Canada-United States transfers to do so more quickly, efficiently and economically. This is possible because of the unique advantages of the Bank's on-line banking system, which can process transactions in both Canadian and U.S. dollars, and the Bank's comprehensive operational capabilities in both Canada and, through its Harris Bank subsidiary, the United States.

National and Multinational Corporations

Corporate markets, particularly in North America, were somewhat more buoyant in 1985 than in the recent past, and the Bank's business with this sector increased significantly.

Net interest income increased, while loan loss experience continued to improve.

However, profound and far-reaching changes in the very nature of the market offer substantial challenges for the future. Although interest income from loans will remain the principal source of earnings for the foreseeable future, fees from financial services are likely to grow in importance. The trends toward disintermediation and securitization of credit are likely to continue, with the result that treasury and capital markets services will become steadily more important to the effective servicing of the corporate market.

To broaden its services to national and multinational corporations, the Bank entered the rapidly expanding Euronote market as well as the fixed and floating rate sectors of the Eurobond market. Underwriting volumes and management positions in the issues of major clients have achieved significant scale and are expected to continue to increase.

Increasingly, the Bank is concentrating its resources upon client relationships and business locations with above-average potential and where a broad spectrum of services can be delivered to the market. At the same time, efforts to enhance the quality of services offered to our customers are continuing.

Project financing activity continued at a high level, notwithstanding the worldwide lull in resource development. During the year, the Bank managed financing for important projects in North America, Australia and the North Sea, generating significant fee income and earning assets.

Technological Developments

The Bank enjoys a strong advantage in technology-based products by virtue of its highly developed computer systems infrastructure.

The Transborder Electronic Payment Service is as useful to corporate customers with large dividend and pension payment volumes as it is to governments and financial institutions.

A new customer and product information system, the first phase of which is now operational, will allow customer profiles, account usage and profitability information to be drawn directly from the transaction processing systems and consolidated by customer and product. This information will be accessible to officers responsible for the management of customer relationships. The system will cover all of Canada in 1986, to be followed by offices in the United States and overseas.

Canadian Activity

Large Canadian corporations and the Canadian subsidiaries of multinational corporations continued to demonstrate increasingly sophisticated demands for financial services. The Bank's response, in addition to the technological advances already described, emphasized high quality training for officers with a creative orientation, continuity of account relationships and strong product support.

A key objective of the Bank is to deepen its corporate relationships in Canada by cross-selling a broad range of services through its global network. An example of this is the role played by the Bank in financing the acquisition of Black Photo Corporation by Scott's Hospitality Inc., a major diversified services company. By understanding and responding to our client's strategy and needs, we were able during 1985 to provide the Scott's group with a variety of banking services ranging from interest rate swaps to assisting with its U.S. banking requirements through Harris Bank in Chicago.

In western Canada, the Bank obtained a new and valued account by designing a financial package enabling Woodward's Limited, the major department store chain in Alberta and British Columbia, to execute a corporate restructuring involving the sale of its extensive real estate holdings. Bank of Montreal-provided credit, treasury, trade finance and cash management services will support Woodward's new and expanded merchandising strategies.

International Activity

The United States remains the Bank's principal corporate market outside of Canada, followed by Western Europe and the Asia-Pacific area. During the year, the corporate banking unit based in the Bank's Tokyo Branch was upgraded, reflecting the importance

not only of this region but also of the Japanese market and Tokyo's emergence as a leading international financial centre.

In September 1985, the Bank established a wholly-owned merchant banking subsidiary in Sydney, Australia. This unit provides money market, foreign exchange, trade finance, capital market and corporate finance services to Australian clients as well as to multinational firms in that market.

Bank of Montreal is a lead manager for Woodside Petroleum in a U.S.$1.65 billion financing for Phase II of the North West Shelf Project off the coast of Australia. The Bank will also provide economic forecasting for this project, which will produce and ship six million tons of liquified natural gas to Japan per year.

Banco de Montreal Investimento S.A.—Montrealbank, headquartered in Rio de Janeiro, added foreign exchange and trade finance to the services offered to its corporate and government clients. In real terms, loans outstanding as at October 31, 1985 showed strong growth over the previous year, while total funds under management increased by 119.3 percent. The Brazilian economy grew strongly during 1985, at an annual rate of 7 percent adjusted for inflation, while the country's balance of payments continued to show a strong surplus.

Treasury Services

The introduction of new products, the expansion of operations and the Bank's ability to take advantage of market conditions resulted in a strong performance by the Treasury area in 1985.

Contribution to profit for 1985 was significantly higher than in 1984, with all Treasury units showing stronger performance than a year ago. This performance together with continued implementation of global strategies and dedication to product development have positioned the Bank well for 1986 and beyond.

The Bank's strategy has been to provide a broader range of sophisticated services, efficient transaction processing and improved customer convenience.

To implement this strategy, the Bank expanded its range of foreign exchange, money market, securities and financial risk management services in 1985. New and enhanced Bank services designed to assist customers in managing interest rate and currency risks included trading in forward rate agreements; an expanded and revitalized marketing network for interest rate and currency swaps, specializing in U.S. and Canadian dollar-based swaps; and extended involvement in financial futures. The new FirstBank Exchange Manager service assists corporations and government entities with offshore borrowings to minimize risks associated with changes in exchange rates and accounting regulations.

These developments contributed to an expanded commercial client base in international money markets and a broadened commercial source of foreign currency deposits.

During the year, the Bank also expanded its commercial base for foreign exchange-related products and services and this reflected favourably on results. A global foreign exchange strategy was implemented, based on specialization by currency, which enhances the timeliness and competitiveness of quotes and the quality of advice to customers. In addition, the Toronto trading room has extended its daily operations until midnight to fill customers' orders. Worldwide, the Bank is reported by *Euromoney* magazine to be the top Canadian bank in commercial foreign exchange.

In the domestic money market, the Bank continued to provide quality account coverage. In an independent survey comparing both banks and investment dealers, the Bank of Montreal Money Desk® was ranked as one of the best in the country, with the performance of Bank staff deemed to be the best. The Bank broadened its range of offerings of fixed rate/fixed term products and services available to large borrowers with the introduction of Mid-Term FirstBank Acceptances.™

In light of international capital market developments, securities-related activities are becoming increasingly important, both in Canada and abroad. The Bank's domestic bond department is an active trader and underwriter of government securities in Canada.

The Bank's domestic operations are complemented by significantly expanded international securities operations. The Bank is active in Eurosecurities trading and underwriting as well as the note issuance facility market, in the capacity of manager, tender panel member and distributor. Bank of Montreal, working closely with Harris, established a distribution capability for United States government securities in London and improved its marketing of Canadian and United States government securities to institutional investors in Japan. These improvements in global securities trading and distribution activities have benefited both Canadian and international customers.

The Bank's continuing automation strategy for Treasury operations has three basic priorities—core functions in major trading centres, telecommunications linkages and management information. Good progress was made in 1985.

The major Treasury operating units are now fully automated with up-to-date systems. Advanced dealer support systems are in place. Attention in 1986 will focus on North American loan and securities transactions, and further upgrading of the New York payments operation.

During the year, new trading facilities were opened in London and Tokyo. In London, the increase in business since the move to 9 Queen Victoria Street only three years ago required an expanded dealing room. In Tokyo, the move into new branch premises provided an opportunity to install expanded dealing facilities to accommodate increased activity.

®-Registered Trade Mark of Bank of Montreal
™-Trade Mark of Bank of Montreal.

Technology

Investment in systems development and advanced technology paid significant dividends in 1985 in customer service, new products, cost control, risk management and financial reporting.

Technology has been important in improving the level of customer service, which continues to be a priority throughout the Bank. Domestic branch staff, for example, spend more time with customers, thanks to centralized filing of personal cheques at regional data centres. This has also permitted significant cost savings through automation and efficiencies of scale. New telephone message centres serving several branches, made possible by Bank-owned telephone exchanges, are freeing staff for more customer contact. Some 80 percent of customer telephone inquiries can be answered by these centres.

Effective customer service requires that a banker know the customers and their needs. The customer and product information system for corporate, government and institutional customers was introduced in 1985 and will be expanded in 1986. Customer and product information from the various data banks of the Bank is consolidated for access by account and product managers and Bank management. Ease of access is facilitated by application of advanced relational data base techniques to a distributed network. This same data base will permit management analysis of existing and potential products, customer relationships and markets to better understand customer needs, product profitability and growth opportunities. A similar customer relationship system is being developed for personal banking clients, with implementation scheduled to begin in 1986.

Examples of the ability of technology to create new services include the new Transborder Electronic Payment Service for corporations and an expanded range of flexible mortgage payment options, introduced during the year. The development and implementation of advanced switching technology made possible the achievements in domestic and international ABM sharing described elsewhere in this report.

During 1985, the application of evolving telecommunications technology and further migration to Bank-owned communication facilities produced significant cost savings while improving the effectiveness of communications within the Bank. In 1986, use of new high bandwidth digital technology will increase the capacity of the Canadian network and further reduce costs.

In the area of risk management, the Bank introduced an improved information system for non-performing loans, installed the first phase of a new integrated international payments system in New York and completed installation of a global limits control system in Treasury operations around the world.

The Bank's integrated financial system, which is the accounting linkage between banking transaction processing and financial and management reports, routinely processes more than 300,000 general ledger entries per day and provides responsibility centre accounting to monitor the performance of the various profit centres of the Bank.

Harris Bank's computer systems already function in concert with Bank of Montreal systems where necessary, with connections for statutory reporting, transborder funds flow and marketing support. Over the longer term, they will provide new products and systems support for the banks and their customers worldwide.

The Bank's systems strategy has been simple, but effective. Initial work concentrated on automating basic transactions. These have included cheque clearing, the on-line banking system, MasterCard, mortgages, securities and other Treasury operations.

The present emphasis is on completing the interconnection of existing transaction systems such as Canadian on-line banking, the international payments and the global loans systems and on the further development of information systems to serve both the Bank and its customers.

In 1985 alone, technology-related expenditures amounted to approximately $370 million in Bank of Montreal and Harris.

Risk Management and Control

The Bank processes well over one billion transactions annually. Dealing volumes average in excess of $11 billion daily and international funds transfer transactions are in the order of $10-15 billion daily.

Each transaction involves some risk, if only because of the volume, the number of people and the number of locations involved. To these must be added a host of other risks depending upon the nature and size of the transaction and upon the external environment.

These factors make it essential that the highest priority be given to assessing and managing risk, bearing in mind that the first responsibility of the Bank is the safety and prudent management of the funds entrusted to it by its depositors and shareholders. Effective risk management ultimately depends upon a well-trained, capably-directed staff, operating within clearly formulated policies, and upon independent monitoring and reporting, all supported by modern technology.

Each banking group, under the direction of the Chief Operating Officer, manages exposure to risk within its jurisdiction in accordance with corporate policies and pursuant to explicit delegation of authority. While each group maintains its own supervisory and monitoring systems, internal control is independently monitored at the corporate level. The principal, although not the only, agencies of internal control are the Corporate Audit and the Credit Policy staffs, both of which report independently of line channels. The role of the Credit Policy staff is described below. The Corporate Audit Department conducts regular audits, of which there were almost 1,000 during 1985. Major functional audits, which may involve a number of Bank units, are also undertaken from time to time. Audit results, as well as the follow-up to verify corrective action, are reported to the Bank's Board of Directors and to its Audit Committee.

The Bank's approach to three major types of risk is outlined below.

Credit Risks

The Bank's credit approval and management system has been restructured over the past three years; the improvement in loan loss experience is, in part, a reflection of these efforts.

Strict observance of centrally determined credit policies and procedures is matched by decentralized decision-making for most loans. This balances the objective of efficient customer service with that of a sound and profitable credit portfolio.

Credit policies are established and reviewed at the corporate level and deal with loan and portfolio quality issues, credit administration, lending philosophy, ethical issues, credit granting authority and qualification of lending officers. Each banking group issues more detailed lending directives from time to time, consistent with the foregoing.

The Bank employs a "two-track" credit granting system. With the exception of certain small loans, lending decisions require the approval of at least two qualified officers, one of whom must be a credit officer providing an independent assessment of the risk. Larger or higher risk loans require approval by progressively more senior officers. The largest credits are referred to a committee of senior officers for approval. Certain credits must be referred to the Chief Executive Officer and to the Executive Committee of the Board for concurrence.

All existing commercial loans are risk rated at regular intervals and those of unacceptable quality or displaying signs of serious deterioration are placed under special surveillance. Loans requiring close attention to avoid loss to the Bank are placed under the administration of specialist units.

The qualifications of every commercial lending officer are reviewed at regular intervals by a panel of experienced officers. Their decision governs the eligibility of individuals for appointment to such positions as well as the level for which they are qualified. Similarly, specific lending authority limits are recommended based upon the individual's record and experience. This authority, however, is delegated through management channels, not by the reviewing panel. Officers who fail to qualify may receive conditional appointments with remedial training, may be transferred to other areas of the Bank or may choose to retire.

The Credit Policy Staff have four principal areas of responsibility. The first is to provide staff support to the Credit Policy Committee. The second is functional responsibility for the quality of lending personnel. This includes administration of the qualification and delegation process by which officers are accorded lending authority, as well as the performance appraisal of credit officers and the review of training standards and curriculum for lending and credit personnel. The third is loan review, which constitutes a continuous review of the loan portfolio, sufficient

to permit the senior credit policy officer to certify each quarter as to the proper valuation of the loan portfolio and the adequacy of the reservations placed against it. In discharging this responsibility, he works closely with the Chief Auditor of the Bank. The fourth responsibility requires that the senior credit policy officer maintain an overview of the Bank's lending processes and procedures and attest at least quarterly as to their adequacy and observance.

The Corporate Audit Department regularly audits the loan portfolios of credit granting units. While a primary objective of the audit process is to verify the proper functioning of internal control procedures and adherence to Bank policies and authority limits, asset valuations and risk ratings are verified by credit auditors, themselves experienced credit officers.

Operations Risks

Operational losses have been low because of the security and control environment and heavy investment in training and technology. Technology, however, brings its own risks. The Bank's systems development and testing procedures, security measures and the use of backup systems substantially reduce the risks of unauthorized access to data and of system failure.

With each advance in electronic funds transfer in Canada and internationally, the Bank has introduced new controls over the authorization and settlement of transactions and over the accounting systems involved. Basically, the Bank relies upon careful testing and audit control of new systems, upon both physical and logical security measures, and upon regular audits and security reviews.

The credit risks inherent in daily payment transactions with other banks, particularly with the enormous increase in volumes and the implementation of electronic funds transfer, have led to new and more complex information and control requirements. Differences in timing of outgoing payments and receipts of funds during the day can cause temporary but substantial exposures if funds are paid out before reimbursement is received. Normally, the outgoing payments are covered before the close of business, hence the term "daylight overdrafts". Until cover is provided, however, they are a credit exposure.

The United States Federal Reserve system will put in place in March 1986 a voluntary system of monitoring and controlling such daylight overdrafts. The Bank's New York Branch currently processes on average some $10 billion in electronic funds transfers daily, and its automated system is being upgraded to provide real-time reporting of such transactions, permitting the Bank to conform to these new Federal Reserve standards.

A no less important security requirement involves the billions of dollars in cash, securities, travellers cheques and other assets held in the Bank's vaults and safety deposit boxes. While physical and procedural security is the responsibility of individual banking groups, this is regularly monitored and reported on by the Corporate Audit and Security departments.

Treasury Risks

Adequate funds must be available at all times to meet the Bank's obligations. For several years, the Bank has had in place a formal, disciplined liquidity policy. Liability management is an important element of liquidity policy, and close attention is paid to diversification of deposit sources and maintenance of a broad deposit base. However, equal emphasis is given to asset management, and the policy of the Bank requires the maintenance of a pool of highly liquid assets over and above statutory requirements.

At the end of 1985, combined Bank of Montreal and Harris liquidity totalled $19.3 billion, compared with total statutory requirements of $2.3 billion.

As a major participant in foreign exchange markets, the Bank must manage position risk resulting from the purchase and sale of different amounts of foreign currencies and from the Bank's own investments, such as equity investments in foreign subsidiaries. Position limits in each currency are delegated to individual dealing units, and actual positions are monitored daily by a control group independent of the trading function. Because of the number and location of major dealing units, the Bank is able to manage open positions around the clock. This not only facilitates the control of risk but enhances the ability of the Bank to accommodate the needs of its clients.

The Bank sets customer and country limits for foreign exchange dealing in order to control the risk of customer "fails". An automated real-time system, in place at major dealing locations, monitors individual exposures, both money market and forward foreign exchange, against pre-authorized credit limits. This information is available at all times to each dealer.

The Bank manages its asset and liability maturity profiles to increase Bank profits where it is considered prudent to do so while effectively controlling risk. This means forgoing some short term income in order to control exposure to potential losses. Computer simulations measure the impact of possible changes in interest rates, maturities and business volumes. Positions are maintained within established limits and are supported by frequent reporting.

Better risk quantification, augmented by significantly increased use of financial futures and interest rate swaps, resulted in improved results in 1985. More effective control coupled with the ability to respond more quickly will permit measured increases in the amount of risk considered acceptable by the Bank.

Corporate Activities

The Bank Family

Worldwide, the Bank and its subsidiaries comprise a family of more than 33,000 employees. While a majority are employed in Canada, the Bank's international presence is reflected in the large number who are employed in other countries. Of a total of 6,800 foreign-based personnel, 5,300 are employed in the United States and 600 in Brazil. The remaining 900 are located in a variety of other European, Pacific Rim, Latin American and Caribbean locations.

Some 26,500 Canadian employees are distributed across Canada, with 30 percent located in Western Canada, 40 percent in Ontario and 30 percent in Quebec and the Atlantic Provinces.

A key strategy pursued by the Bank over the past several years has been to increase the continuity of job assignments in order to optimize the benefits of employee training and development, and to increase the continuity of customer-employee relationships within communities. On average, Bank employees are 35 years old and have worked with the Bank for nine years. The senior management group is slightly older, and has been with the Bank an average of 16 years.

A fundamental key to the success of the Bank is dedication to efficient customer service, supported by advanced information systems and technology. Currently, 82 percent of Bank employees serve customers directly or develop and maintain the systems and operating procedures required to do so. The proportion of employees in administrative roles has decreased to a current level of 18 percent, from 22 percent at the end of 1983.

Not surprisingly, bankers require improved qualifications in today's competitive market. In addition to the Bank's own intensive training and development programs, the formal educational level of our employee population is being improved by focused recruitment. Currently, 20 percent of our management population hold university degrees or equivalent education. Some 41 percent of management employees recruited over the past two years hold similar qualifications.

Training

In 1985, the Bank provided over 100,000 days of training. This represents an increase of approximately 90 percent over 1984, and is almost triple the days of training provided just two years ago. The training budget is in the order of $25 million annually.

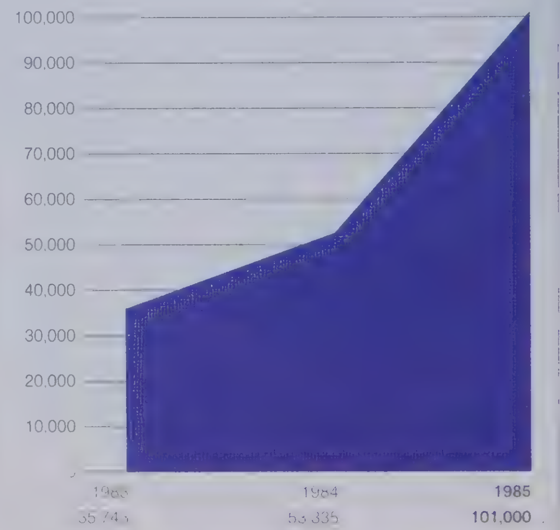
The core skill-training curriculum was completely redesigned. All programs now comprise individual units directed at developing or improving specific skills based on actual job requirements.

Video cassette recorders installed in branches and Commercial Banking Units across the country support customer service training. Results have been gratifying. We are now able to reinforce or upgrade skills more effectively, while the employee need spend only a minimum time off the job for training.

Future emphasis will be placed on developing knowledge of specialized services. In Domestic Banking, branch staff training now incorporates comprehensive courses on personal financial products and services. Training in computer applications will be further developed to meet increasingly sophisticated customer requirements and to support the Bank's productivity goals.

Notwithstanding a significant shift of training to the workplace during the past year, classroom facilities constructed over the last three years in Montreal, Calgary and Toronto operated near capacity. A new Toronto training facility was completed at year-end, incorporating advanced audiovisual technology; the centre will also develop training materials for Bank staff worldwide.

Total Number of Days Spent in Training by Employees



Employee Relations

Staff confidence requires two-way communication. A revised Employee Opinion Survey and a new Management/Executive Opinion Survey are now being used to gauge employee attitudes at all levels; approximately 15,000 employees participated in surveys in 1985. Results have shown improvements in all key employee satisfaction indicators. Particularly large improvements were recorded in employees' perceptions of the level of customer service, management/employee relations, workplace appearance and recognition of personal contributions.

The Response Program, initiated in November 1984, provides an opportunity for employees to make confidential inquiries to Bank executives or department heads. Over 1,000 employees have participated in the program. Questions have generally concerned compensation and benefits, staffing and employee relations, as well as Bank operations and services.

The Personnel Suggestion Plan encourages Bank employees to submit ideas and suggestions which help improve Bank operations and growth. The program provides financial rewards to employees related to the magnitude of savings realized.

A recent award of $10,000 was made to Ms. Nancy Williams, an Operations Support Analyst in the Vancouver Regional Data Centre. Ms. Williams' suggestion related to improved processing of Canada Savings Bond issues and redemptions.

Fair application of the Bank's policy linking remuneration to merit is important to employees. Employment and promotion are based on ability, and pay increases are explicitly linked to performance.

Pension Fund Society

The Bank's Pension Fund Society celebrated its centenary in 1985. The first Bank of Montreal pension plan was incorporated by an Act of Parliament on May 1, 1885, well before enactment of any legislation to regulate or encourage pensions in Canada. The purpose of the Society, as outlined in an early statement, was "paying pensions and providing for the support of officers and employees of Bank of Montreal, incapacitated through age and infirmity; and upon death of employees, paying annuities to widows and children."

Today, the Pension Fund Society and other trustee-supervised plans provide pensions for eligible employees. The major pension plans cover employees in Canada, the United Kingdom and the United States; in addition, Harris Bank maintains a plan for its employees.

Pension assets for all Bank plans were $700 million in 1985. Assets of the Pension Fund Society were $640 million in 1985. Recent investment results have significantly exceeded the rate of inflation.

The liabilities of the pension plans have increased, reflecting updated assumptions and the inclusion of pension supplements up to October 31, 1985 in the Pension Fund Society. Even after assumption of these liabilities, the pension funds in the aggregate as at the dates of the latest valuations were more than fully funded.

The Bank in the Community

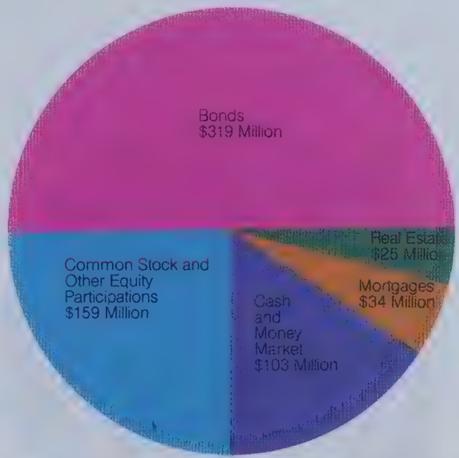
The Bank plays an important role in national affairs. It is also part of the social fabric of nearly 600 communities across Canada.

This social responsibility takes many forms. As an important national institution, the Bank contributes to discussion of major issues of public concern. It submits briefs to Parliamentary committees and to federal and provincial agencies. Bank executives speak publicly on issues of the day, and articles or interviews are published by the press.

The Bank produces booklets and audiovisual presentations on personal finance and on small business management. Special attention was given to retirement planning this year with a booklet entitled *Sixty Plus* and two audiovisual presentations on financial management for retirees.

In western Canada, the Bank participates in production of *Maturity Magazine,* aimed at older Canadians. It is distributed free, has a circulation of 130,000, and offers information on such topics as nutrition, finance, and leisure.

Pension Fund Society
Market Value of Investment Portfolio
($ in millions)



The Bank's yearly Economic and Agricultural Outlook Conferences, held in major centres across Canada, contribute to an understanding of economic trends, and help business people and farmers.

Employees, through the nationwide Speakers Bureau, donate their time to speak to community groups about personal financial management and other banking issues. More than 3,000 talks were given by staff in 1985, reaching more than 200,000 Canadians.

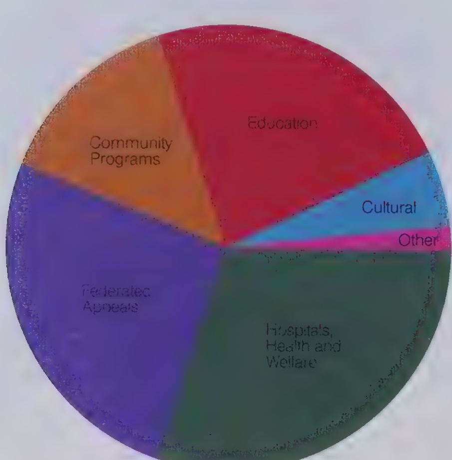
In another dimension, Bank employees—independent of the Bank—make major contributions of time and money to worthy causes, individually and through community organizations. Charities organized by employees, using Bank facilities, raised $1 million nationwide in 1985. Money was donated to the United Way as well as to numerous other charities specified by individual donors. The Our People Fund in Ontario is the leading employee charity in the province in terms of per capita contribution, annually raising over $500,000.

Employees also hold bake sales, raffles, carnivals, craft sales and other fundraising activities. In Calgary, for example, area managers were "auctioned off" to branches for one day's work, with the proceeds going to charity. Similarly, the Chairman hosted a luncheon in the Bank's Executive Dining Rooms for 11 employees who "bid" with donations to the Our People Fund.

Employees at many branches set up events and outings for senior citizens. Thunder Bay employees, for example, organized a bingo for 600 seniors, donating a variety of prizes. British Columbia employees sponsored a Seniors Olympics on Vancouver Island.

Employees of all Quebec branches collected funds for the Telethon of Stars, which raised $135,706 for Ste-Justine Hospital for Children and the Montreal Children's Hospital. After the devastating tornadoes in Barrie, Ontario, employees contributed to disaster relief above and beyond the Bank's own donation.

Allocation of Bank Donations



Individual employees are Scout leaders, organize fund-raising marathons, serve on school boards, work as hospital volunteers, train junior athletic teams and donate hours to community charities.

Staff also join together in social events, such as Christmas parties for the children of employees and family picnics, as well as to help colleagues and their families in need. They have purchased wheelchairs, helped defray costs of a child's liver transplant, and come to the aid of fellow workers facing personal crises.

The Bank itself also donates to charitable causes and institutions, at the local level and nationally. In 1985 some $3.1 million was donated.

Decisions are guided by a formal Donations Policy. According to this policy, the Bank's basic objective is "to make a constructive contribution to the quality of life of the communities it serves.

"In its charitable giving, Bank of Montreal recognizes a dual responsibility; first, to support worthy causes of a charitable nature in Canada and elsewhere where it has a significant presence and, second, carefully and judiciously to manage the shareholders' funds from which its charitable donations are made.

"Accordingly, the Bank may give financial support to eligible and worthy causes, institutions or organizations whose work benefits the community at the local, regional or national level and also in foreign countries where the Bank has significant branch offices or subsidiaries.

"In its charitable giving, the Bank will avoid support of activities or causes which discriminate in their activities, for example, on the basis of colour, sex, race, nationality or creed."

Within the general framework set out above, the Bank may make charitable donations to worthy institutions, organizations or causes within the following broad categories:

- Health and Welfare: e.g., federated appeals, hospitals.
- Culture: e.g., museums, art galleries, music, theatre, ballet.
- Civic: e.g., community projects, youth organizations.
- Higher Education: e.g., campaigns of public post-secondary degree-granting institutions, research and development, university chairs, scholarships and matching gift programmes.
- Other and Special: e.g., pollution control, conservation, disaster relief.

The Bank aims to contribute funds equitably, taking into account regional aspects, as well as the degree of need, worthiness of the cause, availability of other sources of funds and other relevant considerations. The Bank's giving may, as appropriate, be for either capital or operational purposes. The Bank will not normally contribute to endowments, except for university chairs.

In recognition of the fact that donations are made from shareholders' funds, the Board of Directors has established a Donations Committee which reports annually to the Board.

The Chief Executive Officer is responsible for executing policy.

Every year, thousands of requests for money or other aid are received. Each proposal is studied carefully. It is unfortunate that not all deserving causes can be supported.

Enquiries about the operation of the Bank's Donations Policy should be directed to the Secretary of the Bank.

Over the past year, the Bank made major donations to over 20 hospitals, health research centres and medical foundations across Canada, as well as to many associations promoting research and rehabilitation in specific areas.

The cultural life of Canada is also of vital interest to the Bank and deserving of support. The Bank sponsored concerts by the Montreal Symphony Orchestra in Toronto and Tokyo. Donations were also made to other Canadian symphonies and youth orchestras in Vancouver, Banff, Calgary, Edmonton, Winnipeg, London, Kitchener and Toronto.

Smaller occasions also receive Bank support. The Bank this year sponsored a concert by Canadian pianist Jon Kimura Parker at the Aldeburgh Festival in England; an exhibit entitled Cinéma Québec at the Art Institute of Chicago; and donated to the Children's Broadcast Institute in Toronto, which creates educational programs for children.

The Bank has a tradition of supporting universities across Canada. In 1985, we funded establishment of the Bank of Montreal Chair in Finance and Banking at McGill University. This chair will support excellence in both teaching and research at the university and benefit men and women preparing for careers in business and finance. Bank of Montreal chairs were previously established at the University of British Columbia and at Queen's University. Other financial support is provided to a wide range of universities across the country. In addition, the Bank matches donations made by employees and directors to institutions of higher education under its Matching Gift Program.

Among several gifts towards historic preservation, including a donation to Heritage Canada, the Bank helped support restoration of the Second World War Corvette HMCS Sackville, which will be berthed at the Maritime Museum in Halifax as a floating exhibit.

The Bank also presented the historic Newfoundland Savings Bank building in St. John's, built in 1849, to the city, which will use this notable building as an archive or museum.

The Bank's own de Maisonneuve House on Place d'Armes in Montreal has been restored in such a way as to preserve the character of the building's original design, which dates from before the First World War.

Similar restoration work was undertaken on the historic Molson Bank building, two blocks away. Again, the Bank concentrated on maintaining Old Montreal's architectural heritage.

In the area of sports, the Bank sponsored the Bank of Montreal Nations Cup for international team competition in equestrian show jumping at Spruce Meadows in Calgary and at the Royal Agricultural Winter Fair in Toronto. These are the only Nations Cup events held in Canada, and are among only four such internationally sanctioned events held in North America. Such contests provide Canadian athletes with an opportunity to represent their country as they pit their skill against competitors of international excellence. The Bank also supported local sports by funding a skating rink in Eastend, Saskatchewan; the Canadian Blind Sports Association in Ottawa; the Quebec and the Canada Games; the Rugby Union of Winnipeg; and the Canadian Games for the Physically Disabled in Sault Ste. Marie.

Harris Bankcorp, Inc.

Harris Bankcorp, Inc. of Chicago marked its first full year as a wholly-owned subsidiary of Bank of Montreal with record profits. It recorded profits of U.S. $54.6 million for the 12 months ended October 31, 1985. This represented a 52 percent improvement over the previous 12 months.

With a strong customer base throughout the American midwest, in itself a major market, Harris, with 4,700 employees, operates nationwide and provides credit and non-credit services to businesses, governments, financial institutions and individuals. Its marketing activities during the year were matched by a substantial increase in staff devoted to developing and managing financial products.

Harris' national presence was strengthened during 1985 as a result of the association with Bank of Montreal. Representative offices and subsidiaries were established in New York and California. Definition of market responsibilities between Bank of Montreal and Harris enabled both banks to focus on particular areas of specialization, strengthen their capacities in these areas and work together effectively.

Bank of Montreal's larger capital base and international network helped Harris to assume lead bank positions with a number of major United States corporations. Harris also established significant cash management and other operations-intensive relationships with the United States offices of Bank of Montreal corporate customers. Harris' traditional foreign exchange expertise complements Bank of Montreal's recognized excellence in this field.

Similarly, Harris has been able to refer United States-based opportunities in specialized areas such as commercial real estate financing to Bank of Montreal.

Bank of Montreal, as anticipated, provided Harris and its customers with a broader "window on the world".

Harris Futures Corporation has worked closely with Bank of Montreal offices in Toronto, London and New York. In United States government bonds, for which Harris is a primary dealer, it has supported the securities transactions arranged by the London, England staff of Bank of Montreal. During the initial four months of this joint effort, substantial amounts of United States government securities were sold by Bank of Montreal's London office. Harris and Bank of Montreal are also exploring opportunities for Harris to distribute Canadian government bonds in the United States.

The two banks are working together to provide products applicable in both the Canadian and United States markets. The Transborder Electronic Payment System (TEPS), discussed earlier in this report, is the first such product. Consistent with realizing the high potential of technology-based products, Harris is increasing its investment in systems development.

Harris has about U.S. $38 billion in trust assets over which it exercises some form of responsibility, such as investment management and asset servicing. Of this, U.S. $15 billion is under Harris' discretionary management. In addition, Harris is indenture trustee for about U.S. $22 billion in outstanding bond issues. In 1985, it processed approximately 250,000 security transactions and settled about U.S. $250 billion in trades. These are large volumes by any standard.

The Harris Investment Department is an important source of non-interest income. Money market, municipal bond and foreign exchange trading showed substantially improved results in 1985. An emphasis on customer rather than wholesale trading continues to pay dividends. Harris moved in 1985 to expand its distribution capabilities for municipal bonds. Like Bank of Montreal, Harris offers 24-hour foreign exchange trading desk accessibility for corporate customers. New services, such as one related to "loan options" developed by Harris' Financial Risk Strategy Division and an expanded government Bond product line, have provided profitable new sources of income. Harris Futures Corporation and Harris Brokerage Service, a discount broker, more than doubled fee income over the previous year, supported by new products and increased service levels.

Harris is a leading bank in the Chicago area, in which some 20,000 middle-market companies are located. Its position in this market was confirmed by an independent research study carried out this year. Harris will play an increasingly significant role in Chicago, in the surrounding Midwest and nationwide in providing them with a full range of credit and non-credit services, including trust. Service to these customers benefits from Harris' expanded activities in its corporate and personal banking markets.

Harris' personal banking strategies are geared largely to the opportunities of the Chicago metropolitan area market. These plans place heavy emphasis on further developing deposits, credit card-related services, personal trust services, investment products and Private Banking. Instrumental in this strategy is Harris Trust and Savings Bank itself, along with the eight suburban banks in the Chicago area also owned by Harris Bankcorp. Of these, First National Bank and Trust Company of Barrington was acquired during the year.

Chairman William D. Mulholland traveled to the People's Republic of China in June, his second trip there in seven months. On his most recent visit, he accompanied Cui Yan Xu, Vice Chairman of the Bank of China, to the proposed site of the Three Gorges Project on the Yangtze River. Upon completion, it will include not only the world's largest hydro-electric development, but also important navigation and flood control works.

Pictured here with Mr. Mulholland are Zhang Bang Qi (left), a senior engineer of the Yangtze River Planning Committee; Yang Yi (centre), Deputy Head, Office of the Leading Group for the Three Gorges Group Project; and Madam Huang Li Ni, Deputy General Manager, Energy Finance Division of the Bank of China.

In October, Bank of Montreal was appointed a financial advisor to the Ministry of Water Resources and Electric Power, the first foreign financial institution to be so designated. A number of leading Canadian firms are discussing opportunities for Canadian participation in this project with the Ministry.

President Grant L. Reuber (left) calls on David Hobberlin (centre), co-owner of Hobberlin's Limited of Toronto, along with account manager Brian Mosko. Independent businesses such as Hobberlin's, which celebrated its 100th year in 1985, as well as mid-market and agricultural enterprises, are important customers to the Bank. The Bank aims to provide them with sound advice, high quality service and advanced banking products at a fair cost.

B. Kenneth West (right), Chairman and Chief Executive Officer of Harris Bankcorp, visits with executives of Bristol Myers Company at corporate headquarters in New York City. Richard T. Kent (left), Vice President and Treasurer of Bristol-Myers, and Jonathan B Morris, Assistant Treasurer, review financial reports and discuss the company's varied products. Harris has provided Bristol-Myers with banking services for more than 30 years

Andrea (8) and Kristopher (5) watch their mother, Mississauga, Ontario, homemaker Cynthia DiCarlo, as she uses the new MoneyTrac machine outside a branch in downtown Toronto. First placed in service during 1985, some 60 of these machines will be installed by the end of January, 1986, with more to follow. They permit Bank customers holding specially encoded MasterCards or Multi-Branch Banking cards to obtain statements as often as desired for up to 10 chequing or savings accounts. Multi-Branch Banking Cards are available to all customers on request.

Maureen Forrester, renowned contralto and Chairman of the Canada Council, uses her Bank of Montreal MasterCard to withdraw funds from a CIRRUS-linked automated banking machine in New York City. The Bank joined the CIRRUS network during 1985. Customers travelling in the United States can check their personal bank account balances, make cash withdrawals and obtain cash advances against their MasterCard accounts. The location of the nearest machine can be obtained by phoning, toll-free, 1-800-4-CIRRUS. Encoded MasterCards and Multi-Branch Banking cards issued by the Bank are valid at more than 10,000 CIRRUS machines in 47 U.S. states as well as at Bank of Montreal Instabank machines across Canada

Kenneth D. Taylor (right), Senior Vice President of Nabisco Brands Inc. and former Canadian Ambassador to Iran, is a client of the new Private Banking Centre across the street from Canada's Parliament Buildings in Ottawa. Manager William O'Malley and Customer Service Representative Grace Cowie are part of the team which meets the needs of individuals whose banking requirements, because of business and other activities, are more extensive than those of the average client.

Private Banking Centres also opened during 1985 in Montreal, Toronto, Calgary and Vancouver.

Tokyo has emerged as a major financial centre for the entire Pacific Rim. The Bank's activity there has kept pace with this development. Our representation in Japan dates from 1962. Here, Tokuo Kurisa of the Bank joins Edward Little, Senior Vice President, on a customer call. The Bank's Tokyo branch as well as Corporate and Government Banking offices and Treasury dealing facilities are located in the modern building (centre) opposite the Bank of Japan shown at the left.

Trading rooms, supported by up-to-date information, communications and transaction processing systems, link the Bank and its customers to financial and capital markets in Canada and around the world. In London, Senior Vice President and Branch Manager F. Anthony Comper (left) reviews strategy with Vice Presidents Loretta Hennessey (right) and Brian Watters (centre). Through similar facilities in other major financial markets around the world, the Bank deals in a wide range of financial instruments around the clock.

Annual Financial Statements

TABLE OF CONTENTS

Consolidated Statement of Assets and Liabilities

As at October 31
($ in thousands)

Assets	1984	1985
Cash Resources		
Cash and deposits with Bank of Canada	$ 933,365	$ 936,836
Deposits with other banks	11,292,828	10,324,791
Cheques and other items in transit, net	1,049,740	1,474,270
	13,275,933	12,735,897
Securities Issued or Guaranteed by (note 1)		
Government of Canada	4,265,197	4,991,777
Provinces and municipal or school corporations	338,818	192,807
Other	4,231,274	5,339,723
	8,835,289	10,524,307
Loans (net of reservations for losses of $1,265,532; 1984–$1,096,138)		
Day, call and short loans to investment dealers and brokers, secured	647,265	866,687
Banks	2,547,465	2,791,942
Mortgages	6,235,935	7,182,842
Other	38,497,978	41,124,746
	47,928,643	51,966,217
Other		
Customers' liability under acceptances	3,612,090	4,228,273
Land, buildings and equipment (note 2)	1,110,253	1,269,283
Other assets (note 3)	1,729,211	1,695,724
	6,451,554	7,193,280
Total Assets	$76,491,419	$82,419,701

Liabilities, Capital and Reserves	1984	1985
Deposits (note 5)		
Payable on demand	$ 6,975,369	$ 8,866,947
Payable after notice	16,036,978	18,552,738
Payable on a fixed date	43,659,037	43,968,351
	66,671,384	71,388,036
Other		
Acceptances	3,612,090	4,228,273
Liabilities of subsidiaries, other than deposits (note 6)	634,218	608,727
Other liabilities (note 7)	1,508,050	1,587,265
Minority interest	55,323	55,402
	5,809,681	6,479,667
Subordinated Debt		
Bank debentures (note 8)	1,064,749	1,099,521
Capital and Reserves		
Appropriations for contingencies	324,939	457,101
Shareholders' equity		
Share capital (note 9)		
Preferred shares	650,079	650,079
Common shares	140,995	1,130,186
Contributed surplus (note 9)	807,982	–
Retained earnings	1,021,610	1,215,111
Total capital and reserves	2,945,605	3,452,477
Total Liabilities, Capital and Reserves	$76,491,419	$82,419,701

William D. Mulholland,
Chairman and
Chief Executive Officer

Grant L. Reuber,
President and
Chief Operating Officer

Consolidated Statement of Income

Bank of Montreal

For the Year Ended October 31
($ in thousands except per share amounts)

	1984	1985
Interest, Dividend and Fee Income		
Loans	$5,767,601	$5,786,891
Lease financing	67,230	48,857
Securities	852,355	921,652
Deposits with banks	901,145	1,099,279
	7,588,331	7,856,679
Interest Expense		
Deposits	5,769,881	5,700,915
Bank debentures	111,400	120,008
Liabilities other than deposits	80,646	70,620
	5,961,927	5,891,543
Net Interest Income	1,626,404	1,965,136
Provision for loan losses (note 10)	374,998	428,500
Net Interest Income After Provision for Loan Losses	1,251,406	1,536,636
Other operating income	499,311	682,002
Net Interest and Other Income	1,750,717	2,218,638
Non-Interest Expense		
Salaries	706,808	901,783
Pension and other staff benefits	70,763	94,768
Premises and equipment	287,816	364,821
Other expenses	318,837	426,053
	1,384,224	1,787,425
Income Before Provision for Income Taxes	366,493	431,213
Provision for income taxes (note 11)	78,725	87,646
Income Before Minority Interest	287,768	343,567
Minority interest	4,368	4,382
Net Income	$ 283,400	$ 339,185
Net income per common share (note 12)	$3.37	$3.75

Consolidated Statement of Appropriations for Contingencies

For the Year Ended October 31
($ in thousands)

	1984	1985
Beginning of Year		
Tax allowable	$ 35,533	$155,143
Tax paid	157,633	169,796
Total	193,166	324,939
Changes During Year		
Loan loss experience for the year (note 10)	(364,825)	(329,680)
Provision for loan losses based on five-year average loan loss experience	374,998	428,500
Transfers to and from retained earnings—net	121,600	33,342
Net change during year	131,773	132,162
End of Year		
Tax allowable	155,143	390,337
Tax paid	169,796	66,764
Total	$324,939	$457,101

Consolidated Statement of Changes in Shareholders' Equity

For the Year Ended October 31
($ in thousands)

Class A Preferred Shares (note 9)	1984	1985
Balance at beginning of year	$ 375,086	$ 650,079
Proceeds of the sale of 11,000,000 Preferred Shares—Series 3	275,000	–
Conversion of Class A Convertible Preferred Shares—Series 1—Nil (1984—200 shares) to common shares	(7)	–
Balance at end of year	$ 650,079	$ 650,079

Common Shares and Contributed Surplus (note 9)	Number of Shares	Common Shares	Contributed Surplus
Balance at October 31, 1983	65,383,266	$ 130,767	$ 689,697
Shareholder dividend reinvestment and share purchase plan	4,729,349	9,459	110,096
Stock dividend program	384,622	769	8,177
Conversion of Class A Convertible Preferred Shares—Series 1	200	–	7
Conversion of Bank of Montreal Mortgage Corporation exchangeable debentures	162	–	5
Balance at October 31, 1984	70,497,599	$ 140,995	$ 807,982
Shareholder dividend reinvestment and share purchase plan	6,255,200	53,254	109,706
Stock dividend program	374,199	4,984	4,453
Exercise of Class A Preferred Shares—Series 2 Warrants	298,771	8,809	3
Transfer from Contributed Surplus to Common Shares	–	922,144	(922,144)
Balance at October 31, 1985	77,425,769	$1,130,186	$ –

Retained Earnings	1984	1985
Balance at beginning of year	$ 998,845	$1,021,610
Net income for the year	283,400	339,185
Dividends—Common shares	(135,391)	(149,126)
—Preferred shares	(52,584)	(57,404)
Costs of share issue net of related tax	(4,576)	–
Gain on translation of net investment in foreign operations net of applicable tax	10,203	25,580
Prior period adjustment	(14,660)	–
Transfers to and from appropriations for contingencies—net	(121,600)	(33,342)
Income taxes related to the above transfer	57,973	68,608
Balance at end of year	$1,021,610	$1,215,111

Significant Accounting Policies and Practices

The accounting policies and financial statement formats of Canadian banks are prescribed by the Bank Act and its regulations. The accounting policies followed by the Bank conform in all material respects with accounting principles generally accepted in Canada, except for the accounting for losses on loans, the deferral of gains and losses on the disposal of certain debt securities and the translation of foreign currencies.

The significant accounting policies followed by the Bank are described below:

Basis of Consolidation

These consolidated financial statements include the Bank and all its subsidiary corporations. The purchase method is used to account for all acquisitions. The difference between the cost of the investment and the fair value of the net assets acquired is deferred and amortized over a period not exceeding 40 years.

Investments in affiliated corporations in which the Bank owns 20% to 50% of voting shares are accounted for by the equity method, whereby the income of such corporations is recognized based on the Bank's proportionate share of the earnings.

Securities

The Bank's securities are accounted for on either a trading or investment basis.

Trading account securities are carried at market value, and gains and losses on sale and adjustments to market value are included in income.

Investment securities are accounted for as follows: Equity securities are carried at cost, and gains and losses on sales are included in income when realized. Debt securities are carried at amortized cost. Gains and losses on sale of debt securities are deferred and amortized to income over five years, except for gains and losses on the sale of Treasury bills and similar instruments which are included in income when realized. Any permanent impairment in the value of investment securities is recognized through a charge to income. Liquidity securities are accounted for on an investment basis. Securities which are loan substitutes are accorded the accounting treatment applicable to loans.

Loans

Loans are stated net of any unearned income, unamortized discounts and reservations for losses.

Loan fees are recorded in income when received to the extent that they relate to expenses which have been incurred or services which have been provided by the Bank. Fees received for loan rescheduling and fees received in lieu of interest are deferred and amortized over the term of the loan.

Interest income is recorded on an accrual basis except on loans classified as non-accrual. The accounting treatment for non-accrual loans, which complies in all respects with the regulations of the Inspector General of Banks, is as follows:

	Personal Plan and Credit Card Loans	Sovereign Risk Loans	All Other Loans
Classification as non-accrual	Loans are classified as non-accrual when payments are contractually past due six months.	A loan is classified as non-accrual when: 1. in the opinion of management there is significant doubt as to the ultimate collectibility of principal, in which case a specific reservation is established against the loan, or 2. payment of interest or principal is contractually past due 90 days and there is reasonable doubt as to ultimate collectibility, or 3. payment of interest or principal is contractually past due 180 days, or 4. in the opinion of management it is considered prudent or desirable to cease accruing interest, irrespective of the status of interest or principal payments.	
Accrued and unpaid interest	Accrued and unpaid interest is deducted from current income when the loan is classified as non-accrual.		
	Personal Plan and Credit Card Loans	Sovereign Risk Loans	All Other Loans
Application of subsequent payments	Subsequent payments are applied first to interest, then to principal, unless directed otherwise by the borrower.	Subsequent payments are applied first to interest, then to principal, unless directed otherwise by the borrower.	Subsequent payments are recorded in income only if management has determined that the loan does not require a reservation, otherwise it is recorded as a reduction of principal.

	Personal Plan and Credit Card Loans	Sovereign Risk Loans	All Other Loans
Establishment of reservation	Personal plan and credit card loans are automatically reviewed and written off (see write-off policy following).	Loans are reviewed at least quarterly. If there is significant doubt as to the ultimate collectibility of principal, a specific reservation is established at a level sufficient to provide for the estimated impairment of loan principal. The Bank also maintains general reservations against sovereign risk loans. The purpose of these general reservations is to permit management to provide from time to time against possible loan losses, when in its judgment, circumstances are such as to give rise to concern, even though events may not have occurred which would justify the classification of individual loans as non-accrual. General reservations are prudential in nature and may be established on an allocated or unallocated basis.	Loans are reviewed at least quarterly. If there is significant doubt as to the ultimate collectibility of principal, a specific reservation is established at a level sufficient to provide for the estimated impairment of loan principal.
Write-Offs	Credit card loans are written off when they are six months in arrears. Personal plan loans are written off when they are one year in arrears.	Loans are written off after all reasonable restructuring/collection activities have taken place and the possibility of further recovery is considered to be remote.	

Loan Losses

Actual loan loss experience comprises net new reservations for the year less recoveries against loans previously written off.

The provision for loan losses charged to income is calculated using an averaging formula prescribed by the Minister of Finance designed to average the loss experience over a five-year period.

The difference between the actual loan loss experience and the five-year average provision for loan losses is recorded in the Appropriations for Contingencies account.

Appropriations for Contingencies

The Bank makes appropriations for contingencies with respect to possible unspecified future credit losses through transfers from retained earnings. The portion of the amount of the transfer which is tax deductible is prescribed by the Minister of Finance.

Land, Buildings and Equipment

Land, buildings and equipment are stated at cost less an allowance for depreciation and amortization. Major Canadian properties are depreciated using the sinking fund method, while all other buildings and leasehold improvements are depreciated on a straight line basis over their estimated useful lives. Equipment is depreciated using the declining balance method over its estimated useful life.

Translation of Foreign Currencies

Assets and liabilities in foreign currencies are translated into Canadian dollars at year-end exchange rates. Revenues and expenses are translated at the average exchange rates prevailing during the year. Realized and unrealized gains and losses on foreign currency assets and liabilities, other than those relating to net investments in foreign operations, are recorded in Other Operating Income. Unrealized foreign currency translation gains and losses on investments in foreign branches, subsidiaries and associated corporations are recorded in retained earnings, net of any offsetting losses and gains after providing for applicable income taxes on liabilities and forward exchange contracts used to hedge the investments. Only at such time as they are realized are such gains and losses recorded in income.

1 Securities

As at October 31 ($ in millions)	1984 Total	1985 Total	Within 1 Year	1 to 3 Years	4 to 5 Years	6 to 10 Years	Over 10 Years	No specific maturity
Liquidity								
Government of Canada Treasury bills	$3,993	$ 4,774	$4,774	$ –	$ –	$ –	$ –	$ –
Provincial government securities	310	127	125	–	–	–	2	–
Other debt securities	694	1,697	1,505	55	–	137	–	–
	4,997	6,598						
Loan Substitutions								
Term preferred shares	1,027	1,041	–	–	–	–	–	1,041
Floating rate income debentures	503	324	16	56	202	50	–	–
Fixed rate income debentures	82	79	–	79	–	–	–	–
Floating rate small business development bonds and small business bonds	347	288	106	156	26	–	–	–
Debt of foreign issuers	1,241	1,411	562	278	68	179	306	18
	3,200	3,143						
Investments								
Government of Canada securities	64	–	–	–	–	–	–	–
Other equity securities	214	186	–	–	–	–	–	186
Other debt securities	22	10	7	–	3	–	–	–
	300	196						
Trading	338	587	481	55	8	29	14	–
	$8,835	$10,524	$7,576	$679	$307	$395	$322	$1,245

As at October 31, 1985 the current value of total securities is estimated to be $10,541 million (1984 - $8,842 million).

Securities of Harris Bankcorp, Inc. having a carrying value of $654 million were pledged, where permitted or required by law, to secure liabilities and public and trust deposits.

2 Land, Buildings and Equipment

As at October 31

($ in thousands)	1984 Net Book Value	1985 Cost	1985 Accumulated Depreciation	1985 Net Book Value
Land	$ 203,066	$ 209,473	$ –	$ 209,473
Buildings	501,722	656,968	122,474	534,494
Equipment	228,248	611,598	346,011	265,587
Leasehold improvements	177,217			259,729
	$1,110,253			$1,269,283

Depreciation of buildings and equipment and amortization of leasehold improvements amounted to $99,541 for the year ended October 31, 1985 (1984 - $56,130).

3 Other Assets

As at October 31

($ in thousands)	1984	1985
Accrued interest income	$ 838,846	$ 750,308
Deferred income taxes	313,878	430,722
Goodwill and other valuation intangibles	171,095	159,973
Other	405,392	354,721
	$1,729,211	$1,695,724

4 Geographic Distribution of Assets by Location of Ultimate Risk

(currencies in millions)	As at September 30, 1984 (1) Cdn.$	U.S.$	Other Currencies	Total Cdn.$ Equiv.	As at September 30, 1985 Cdn.$	U.S.$	Other Currencies	Total Cdn. $ Equiv.
Canada	34,883	5,562	53 £ 89 D.M. 37 S.F. 30 Cdn.$ Equiv.	42,387	38,265	4,370	87 £ 188 D.M. 51 S.F. 43 Cdn.$ Equiv.	44,606
United States	108	12,462	41 £ 37 D.M. 7 S.F. 12 Cdn.$ Equiv.	16,625	151	14,274	91 £ 61 D.M. 28 S.F. 24 Cdn.$ Equiv.	20,013
Europe								
United Kingdom	152	1,220	530 £ 79 D.M. 128 S.F. 5 Cdn.$ Equiv.	2,728	247	1,368	472 £ 145 D.M. 30 S.F. 38 Cdn.$ Equiv.	3,162
Italy	37	419	15 £ 77 D.M. 48 S.F. 59 Cdn.$ Equiv.	731	34	339	21 £ 107 D.M. 5 S.F. 86 Cdn.$ Equiv.	684

(1) 1984 data has been restated to conform with the 1985 presentation.

(currencies in millions)	As at September 30, 1984 (1) Cdn.$	U.S.$	Other Currencies	Total Cdn.$ Equiv.	As at September 30, 1985 Cdn.$	U.S.$	Other Currencies	Total Cdn. $ Equiv.
France	58	649	12 £ 93 D.M. 77 S.F. 29 Cdn.$ Equiv.	1,042	58	584	34 £ 73 D.M. 45 S.F. 37 Cdn.$ Equiv.	1,027
Other Europe	255	1,469	46 £ 780 D.M. 289 S.F. 131 Cdn.$ Equiv.	2,882	247	1,138	118 £ 850 D.M. 360 S.F. 179 Cdn.$ Equiv.	2,876
Latin America and Caribbean								
Brazil	212	991	618,757 Cruz. –	1,867	211	952	2,739,659 Cruz. 9 Cdn.$ Equiv.	2,010
Mexico	258	1,129	–	1,745	326	1,073	–	1,801
Venezuela	–	477	–	629	–	444	–	610
Other Latin America and Caribbean	81	656	– 11 D.M. 4 S.F. 61 Cdn.$ Equiv.	1,014	89	649	3 £ 11 D.M. – 64 Cdn.$ Equiv.	1,056
Asia, Oceania and Australasia								
Japan	24	2,748	52 £ 261 D.M. 149 S.F. 507 Cdn.$ Equiv.	4,427	46	1,840	18 £ 202 D.M. 287 S.F. 475 Cdn.$ Equiv.	3,367
Other Asia, Oceania and Australasia	19	1,254	10 £ 38 D.M. 85 S.F. 181 Cdn.$ Equiv.	1,924	35	1,059	13 £ 34 D.M. 118 S.F. 280 Cdn.$ Equiv.	1,886
Africa and Middle East	1	137	3 £ 26 D.M. –	196	1	171	2 £ 19 D.M. 5 Cdn.$ Equiv.	254
Total Assets	$36,088	$29,173	762 £ 1,491 D.M. 824 S.F. 618,757 Cruz. 1,015 Cdn.$ Equiv.	$78,197	$39,710	$28,261	859 £ 1,690 D.M. 924 S.F. 2,739,659 Cruz. 1,240 Cdn.$ Equiv.	$83,352

(1) 1984 data has been restated to conform with the 1985 presentation.

The countries noted separately above each represent an ultimate risk of one percent or more of the Bank's aggregate outstanding securities, deposits with banks and loans excluding mortgages.

Assets are shown net of reservations in source currencies and Canadian dollar equivalents with Canadian dollar equivalents noted for sundry foreign currency outstandings.

The only foreign country from which more than 10% of the Bank's consolidated interest income was derived was the United States, where interest income was U.S. $1,849 million in 1985 (1984–U.S. $881 million).

5 Deposits

As at October 31

($ in thousands)	1984	1985
Deposits by Canada	$ 543,626	$ 1,088,174
Deposits by provinces	215,705	109,552
Deposits by banks	18,831,230	18,918,410
Deposits by individuals	24,647,632	26,684,714
Other deposits	22,433,191	24,587,186
	$66,671,384	$71,388,036

6 Liabilities of Subsidiaries, Other than Deposits

As at October 31

($ in thousands)	Interest Rate	Date Maturing	Redeemable at the option of the subsidiaries beginning	1984	1985
Bank of Montreal Mortgage Corporation					
Series A debentures	7.75%	October, 1987	October, 1977	$ 1,383	$ 1,297
Series B debentures	9.00	February, 1989	February, 1979	1,355	1,325
Series 3 debentures	13.625	May, 1985	June, 1984	50,000	–
Series 4 debentures	11.50	August, 1985	–	75,000	–
Exchangeable debentures (1)	11.75	September, 1991	October, 1986	95,657	95,657
Bank of Montreal Realty Inc.					
Series 1 debentures	13.625	December, 2000	–	100,000	100,000
Notes	16.75	March, 1988	–	75,000	75,000
Mortgages	(2)	(2)	–	7,447	6,842
Bank of Montreal Leasing Corporation					
Series G notes, secured	10.50	February, 1986	–	15,600	15,600
Series I notes, secured	(2)	(2)	–	29,270	103,084
Short term notes, unsecured	(3)	(3)	–	139,781	166,357
Harris Bankcorp, Inc.					
Notes (4)	(2)	(2)	October, 1984	41,732	43,247
Empresa Técnica de Organização e Participaçoes S.A.					
Mortgages	(2)	(2)	–	1,993	318
				$634,218	$608,727

(1) Exchangeable into common shares of the Bank as described in note 9.
(2) At varying rates of interest and varying terms to maturity to 1998.
(3) At varying rates of interest and varying terms to maturity.
(4) Denominated in U.S.$.

The aggregate sinking fund requirements and maturities within and beyond the next five years as at October 31, 1985 are as follows:

($ in thousands)	
1986	$193,479
1987	37,568
1988	109,896
1989	70,417
1990	16,073
Thereafter	181,294
	$608,727

7 Other Liabilities

As at October 31

($ in thousands)	1984	1985
Accrued interest payable	$ 931,709	$ 850,633
Accounts payable and accrued expenses	547,188	703,390
Deferred loan fees	29,153	33,242
	$1,508,050	$1,587,265

Included in Income from Loans is $20,287 (1984 - $13,332) of amortization of deferred loan fees.

8 Bank Debentures

As at October 31

($ in thousands)	Interest Rate	Date Maturing	Redeemable at the option of the Bank beginning	Denominated in U.S.$	1984	1985
Series A	7.50%	April, 1992	April, 1986	–	$ 2,842	$ 2,842
Series C	7.25	February, 1987	February, 1983	–	975	966
Series 3	7.56*	April, 1989	April, 1984	–	75,000	75,000
Series 4	9.625*	August, 1991	August, 1984	–	125,000	125,000
Series 5	7.9375*	December, 1990	December, 1985	100,000	131,440	136,750
Series 6	8.50*	October, 1991	October, 1988	125,000	164,300	170,938
Series 7	16.25	December, 1991	December, 1987	150,000	197,160	205,125
Series 8	15.25	July, 1994	–	30,000	39,432	41,025
Series 9	8.4375*	April, 1996	April, 1989	250,000	328,600	341,875
					$1,064,749	$1,099,521

*Floating rate debentures: interest rate stated is as at October 31, 1985.

All debentures are direct unsecured obligations of the Bank and are subordinated in right of payment to the claims of depositors and certain other creditors. In accordance with the formula prescribed in the Bank Act, the Bank has the capacity, as of November 1, 1985, to issue an additional $398 million of debentures.

The aggregate sinking fund obligations and maturities within and beyond the next five years of the Bank's debentures as at October 31, 1985, are as follows:

($ in thousands)	
1986	$ 36
1987	990
1988	118
1989	75,118
1990	118
Thereafter	1,023,141
	$1,099,521

9 Share Capital
As at October 31

a) Share Capital

Authorized:

200,000,000 Common Shares without par value. The aggregate consideration for all common shares shall not exceed $5.5 billion.

50,000,000 Class A Preferred Shares without par value, issuable in series. The aggregate consideration for all Class A shares shall not exceed $1 billion.

12,500,000 Class B Preferred Shares without par value, issuable in series. The aggregate consideration for all Class B shares shall not exceed $250 million. These shares may be issued in foreign currencies.

Issued and fully paid:

	1984		1985	
($ in thousands)	Number of Shares	$	Number of Shares	$
Common Shares	70,497,599	$140,995	77,425,769	$1,130,186
Class A Convertible Preferred Shares —Series 1	5,799,400	200,079	5,799,400	200,079
Class A Preferred Shares—Series 2	7,000,000	175,000	7,000,000	175,000
Class A Preferred Shares—Series 3	11,000,000	275,000	11,000,000	275,000
		$791,074		$1,780,265

Features of the Class A Preferred Shares are as follows:

	SERIES 1	SERIES 2	SERIES 3
Annual cumulative dividend	$ 2.85	$ 2.50	$ 2.125
Other Features	*Each share is:* —Convertible into one common share, at the holder's option, before May 26, 1991. —Convertible, prior to May 26, 1991, into common shares at the Bank's option at $32.78 per common share, if the Bank's common shares have traded at a weighted average price at or in excess of $36.60 for a period of 20 consecutive trading days. —Redeemable from May 26, 1986 to May 25, 1987 at $36.23 per share, and thereafter at declining prices.	*Each share carries:* —Two Warrants to purchase one common share each at $33.00 per share until December 15, 1988. Holders of the Warrants have the option to exercise either Warrant by delivering one Series 2 Preferred Share plus cash equivalent to the difference between the exercise price and $25.00. *Each share is:* —Redeemable from December 16, 1988 to December 15, 1989 at $25.75 per share, and thereafter at declining prices.	*Each share is:* —Entitled, after February 23, 1989, to a minimum quarterly dividend equal to the greater of $0.53125 per share or one quarter of 75% of the average of the prime rate of the Bank (as defined) times $25.00. —Redeemable from February 1, 1989 to January 31, 1990 at $26.00 per share, and thereafter at declining prices.

b) Exchangeable Debentures

The holders of the $95,657,000 exchangeable debentures of Bank of Montreal Mortgage Corporation due September 8, 1991 currently have the right to exchange the debentures for common shares of the Bank at a price of $33.00 per common share.

Bank of Montreal Mortgage Corporation may redeem the debentures on or after September 8, 1986 at declining premiums. If prior to September 8, 1991 the Bank's common shares have traded at a weighted average price at or in excess of $34.65 for a period of 20 consecutive trading days, the Bank has the right to exchange the debentures for common shares of the Bank at $31.35 per common share.

c) Shares Reserved for Issue

The following table as at October 31, 1985 indicates the maximum remaining number of common shares allocated and reserved by the Board of Directors for issue in respect of:

	Number of Shares
Dividend reinvestment and share purchase plan and stock dividend program	7,759,752
Class A Convertible Preferred Shares—Series 1	5,799,400
Class A Preferred Shares—Series 2 Warrants	13,699,729
Bank of Montreal Mortgage Corporation Exchangeable Debentures	3,315,350
	30,574,231

d) Transfer from Contributed Surplus to Common Shares

On March 7, 1985, with the approval of the Minister of Finance, the Bank increased the authorized number of common shares from 100,000,000 to 200,000,000, changed the terms of the common shares from $2 par value to shares without nominal or par value and established a limit of $5.5 billion for the aggregate consideration for which all such shares may be issued.

Accordingly, $922,144,000 of Contributed Surplus arising from issues prior to March 7, 1985 of common shares was transferred to Common Shares.

10 Provision for Loan Losses
For the year ended October 31
($ in thousands)

The provision for loan losses of $428,500 (1984–$374,998) in the Consolidated Statement of Income is based on the five-year averaging formula prescribed by the Minister of Finance. Actual loan loss experience of $329,680 (1984–$364,825) is charged to Appropriations for Contingencies.

11 Income Taxes
The Provision for Income Taxes recorded in the Consolidated Statement of Income represents the taxes applicable to the income reported therein. The deferred tax portion of this provision represents timing differences related primarily to the recognition of the loan loss provision for tax and financial statement purposes.

The Credit for Income Taxes recorded in Retained Earnings represents the income tax effect related to:
- transfers from Retained Earnings to Appropriations for Contingencies;
- expenses related to the issuance and sale of equity securities of the Bank; and
- gains and losses on liabilities and forward exchange contracts used to hedge the investments in foreign branches, subsidiaries and associated corporations.

For the year ended October 31 ($ in thousands)	1984	1985
Provision for Income Taxes		
Statement of Income		
Current	$157,955	$189,814
Deferred	(79,230)	(102,168)
	$ 78,725	$ 87,646
Statement of Retained Earnings		
Current	$ (74,653)	$ (83,329)

The Provision for Income Taxes recorded in the Consolidated Statement of Income is lower than the amounts that would be computed by applying the combined Canadian Federal and Provincial statutory income tax rate. This is because a portion of interest and dividend income is exempt from tax or because income is taxed at other than the combined Canadian Federal and Provincial statutory income tax rate.

	1984	1985
Combined Canadian Federal and Provincial statutory income tax rate	47.7%	48.1%
Increase (Decrease) in rate resulting from:		
Tax-exempt income from Canadian securities, primarily income debentures, preferred shares and small business development bonds	(20.3)	(14.0)
Lower income tax rate applicable to income of foreign subsidiaries	(7.9)	(13.6)
Other	2.0	(.2)
Effective income tax rate	21.5%	20.3%

12 Net Income per Common Share

Net income per common share has been calculated using the daily average of common shares outstanding. For the year ended October 31, 1985, this average was 75,193,290 (1984-68,414,123). Fully diluted net income per common share was $3.64 (1984 - $3.30) and has been calculated as if: (a) all outstanding Class A Convertible Preferred Shares—Series 1 had been converted into common shares at the beginning of the year, and (b) all outstanding Class A Preferred Shares—Series 2 had been converted into common shares at the beginning of the year with the exercise of the Warrants, and assets at the current rate of leverage had been generated, upon which earnings were imputed using the current rate of return on total assets.

13 Commitments and Contingencies

In the normal course of business, there are various outstanding commitments and contingent liabilities such as commitments to extend credit, foreign exchange contracts and financial futures contracts which properly are not reflected in the financial statements. These also include letters of credit and guarantees, the amounts of which are disclosed below. In the opinion of management, there are no material commitments or contingencies which represent unusual risk and no material losses are anticipated as a result of these transactions.

As at October 31	1984	1985
($ in thousands)		
Guarantees	$1,570,894	$1,557,774
Letters of credit	1,771,654	2,300,327
	$3,342,548	$3,858,101

14 Pension Funds

The Pension Fund Society of Bank of Montreal is the Bank's principal pension plan in Canada, while a number of smaller plans provide pensions to the Bank's executives as well as to employees in other parts of the world.

These plans are non-contributory, with the Bank responsible for all contributions to adequately fund the plans. The Bank has established the Pension Advisory Committee of the Board of Directors to provide guidance and report on plan affairs to the Bank's Board of Directors. As at the dates of the latest actuarial valuations, the pension funds were fully funded in the aggregate. Pension expense during 1985 was $20,948,000 (1984–$15,317,000).

15 Lease Commitments

As at October 31

Annual contractual rental commitments of more than $25,000 on leased buildings and equipment are as follows:

($ in thousands)	
1986	$ 74,536
1987	68,072
1988	59,811
1989	52,129
1990	44,438
Thereafter	503,767

16 Legal Proceedings

In 1981, legal proceedings were initiated against the Bank in Alberta and British Columbia alleging that in May, 1979 the Bank, as a creditor, acted improperly in its appointment of the original Receiver and Manager under debentures it held from Abacus Cities Ltd. ("Abacus").

The Alberta action was commenced by the Trustee in Bankruptcy of Abacus against, amongst others, the Bank and the original Receiver and Manager claiming $300 million.

The British Columbia action was commenced by three shareholders and former officers of Abacus claiming damages from the Bank and others. Thorne Riddell and Company and Vernon C. Morrison, C.A., co-defendants, have made a third party claim against the Bank for indemnification. The Bank has denied liability in the third party proceedings.

Judgments, on preliminary applications by the Bank and other defendants, have resulted in the dismissal of both the Alberta and British Columbia actions. Both judgments are currently being appealed.

The Bank's Alberta and British Columbia counsel have advised, in respect of the Alberta and British Columbia actions, that based on their knowledge of the facts, should the appeals be successful and the actions be further prosecuted, there are reasonable defenses against the imposition of any liability and that no substantial damages ought to be awarded against the Bank.

Statement of Responsibility for Financial Data

The consolidated financial statements of Bank of Montreal have been prepared by, and are the responsibility of, the Bank's management. The presentation and information provided therein have been prepared in accordance with the provisions of the Bank Act of Canada and with appropriate generally accepted accounting principles in Canada, and include amounts based on informed judgments and estimates of the expected effects of current events and transactions.

In meeting its responsibility for the reliability of financial data, management relies on comprehensive internal accounting, operating and system controls. The Bank's overall controls include an organizational structure providing for effective segregation of responsibilities, delegation of authority and personal accountability, and careful selection and training of personnel; the application of accounting and administrative policies and procedures necessary to ensure adequate internal control over transactions, assets and records; as well as a continued program of extensive internal audits. These controls are designed to provide reasonable assurance that financial records are reliable for preparing financial statements and maintaining accountability for assets, and that assets are safeguarded against unauthorized use or disposition.

The Board of Directors oversees management's responsibilities for financial statements through the Audit Committee, which is composed solely of directors who are not officers or employees of the Bank. The Shareholders' auditors and the Bank's Chief Auditor have full and free access to the Audit Committee to discuss audit, financial reporting and related matters.

William D. Mulholland,
Chairman and
Chief Executive Officer

Grant L. Reuber,
President and
Chief Operating Officer

Robert B. Wells,
Senior Vice President
Accounting and Control

November 26, 1985

Auditors' Report

To the Shareholders of Bank of Montreal

We have examined the consolidated statement of assets and liabilities of Bank of Montreal as at October 31, 1985 and the consolidated statements of income, appropriations for contingencies and changes in shareholders' equity for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of Bank of Montreal as at October 31, 1985 and the results of its operations for the year then ended in accordance with prescribed accounting principles applied on a basis consistent with that of the preceding year.

Coopers & Lybrand

Coopers & Lybrand

Peat, Marwick, Mitchell & Co.

Peat, Marwick, Mitchell & Co.
Chartered Accountants

Montreal, November 26, 1985

Management Analysis of Operations

TABLE OF CONTENTS

Introduction

The purpose of this section is to provide an analysis of the major factors that affected the 1985 financial performance of the Bank.

For analytical purposes the Bank's results are segmented in two ways. First, the results of Harris Bankcorp, Inc. ("Harris") have been separated from those of the Bank for purposes of various analyses in this section. The Bank of Montreal excluding the impact of Harris is referred to throughout this section as the "Parent Bank".

Harris was acquired on September 4, 1984 and therefore the 1984 results included two months of Harris' income and expenses, although in 1985 Harris results are included for a full year. Consequently, year-over-year comparisons and longer term trend analyses show significant variances which are more readily understood by a separate review of the Parent Bank and Harris results.

Secondly, the Bank's financial data is also segmented between Domestic and International Operations and this is provided as supplemental information later in this section.

Clarification of terminology with regards to the *taxable equivalent adjustment* and the method of accounting for loan losses will also assist the reader in understanding this section.

Taxable Equivalent Adjustment

The taxable equivalent adjustment is made to increase net interest income and income taxes to recognize the tax-exempt nature of interest income from small business development bonds, income debentures and term preferred shares. Harris has similar instruments to which the same principle applies. As a result of holding such tax-exempt instruments, both net interest income and the provision for income tax of the Bank are less than the amounts which would result if the income from these securities was taxable. The taxable equivalent adjustment increases interest income and taxes to such greater amounts to more clearly reflect the economic yield on these instruments. There is no effect on the Bank's net income. The amounts of these adjustments in the last five years are:

Year	$Millions
1981	222
1982	220
1983	155
1984	127
1985	175

Accounting for Loan Losses

Loan loss reservations are comprised of specific and general reservations against loans and are deducted from loan balances shown on the balance sheet. They are *not* included in determining the equity capital of the Bank. Loan loss reservations are intended to provide against the possibility that loan principal will not be repaid.

Loan loss experience is the current year's loss experience and is comprised of net new reservations made during the year less principal recovered on loans previously written off.

Provision for loan losses is the amount deducted from income determined in accordance with an averaging formula mandated by the Minister of Finance. Essentially it is the average ratio of loan loss experience to eligible loans for the most recent five years, applied to total eligible loans at September 30th of the current year.

Eligible loans as defined by the Minister of Finance basically includes all loans and securities (other than those guaranteed by the government of Canada or a province) as well as customer acceptances, guarantees and letters of credit.

The amount charged to income in respect of loan losses is the provision for loan losses which may be greater or less than the actual loan loss experience for the year.

The difference between the loan loss experience and the provision for loan losses is charged or credited, as the case may be, directly to the appropriations for contingencies, one of the capital accounts on the balance sheet of the Bank.

As a result of using the averaging formula described above, the reported results of Canadian banks are not comparable to other international banks whose jurisdictions normally require an equivalent to the loan loss experience to be charged against earnings.

The averaging formula tends to smooth the year-over-year changes to the provision. As a result the Bank's provision for loan losses has increased in both 1984 and 1985 even though the loan loss experience in each of these years has declined. To eliminate this effect, there is reference in various parts of the Management Analysis to income determined on the *Loan Loss Experience Basis* which represents a restatement of reported net income for the year obtained by substituting the actual loan loss experience for the provision for loan losses in the income statement (and adjusting for any tax effect).

Summary

In 1985 the Bank of Montreal reported consolidated net income of $339 million compared with $283 million in 1984, an increase of almost 20%.

On a loan loss experience basis, consolidated net income for the year was $391 million, 35% higher than the $289 million on a similarly adjusted basis in 1984.

The improvement from last year both on a reported and loan loss experience basis is due to a number of factors of which a major factor is the improvement in net interest income.

The decline of interest rates during the year provided improved margins on liquid assets. In addition, a higher return was achieved on foreign currency earnings from International Money Market Operations. These increases more than offset the upward movement in the cost of customer deposits relative to the prime rate.

The provision for loan losses has increased, due to both the inclusion of Harris for the full year and the averaging formula. However, loan loss experience for the year has shown another steep decline despite a further substantial increase in general reservations.

Other operating income has increased by $183 million over 1984 virtually all of which is accounted for by the inclusion of Harris in the consolidated statement of income for a full year. However, excluding non-recurring gains in 1984, growth by the Parent Bank in this category exceeded 9%, with major contributions from foreign exchange dealing and MasterCard.

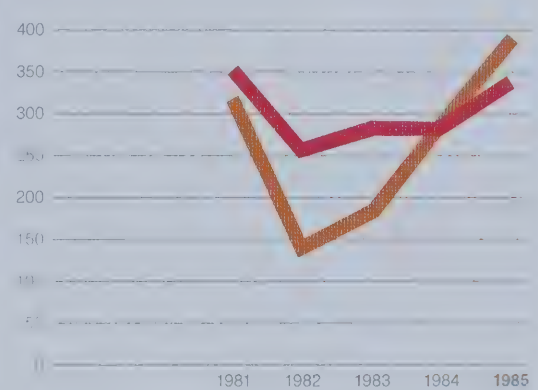
Finally, non-interest expenses increased by $403 million or 29% over 1984. Again, the major part of this increase is attributable to Harris. The rate of growth in non-interest expenses of the Parent Bank was 3.7%.

Average assets have increased by $12.8 billion with the inclusion of Harris the principal factor. Loans of the Parent Bank increased by 4.0% mainly in mortgages and charge card balances. The Bank continues to place a strong emphasis on the enforcement of credit standards in the commercial and consumer lending process.

The consolidated return on average assets for the year was 0.43%, as compared with 0.42% last year. On a loan loss experience basis the return was 0.49% up from the 0.43% recorded last year.

The return on assets for the year of the Parent Bank alone was 0.43% on a reported basis and 0.51% on a loan loss experience basis. The return on assets of Harris on a loan loss experience basis was 0.64%.

Net Income
($ in millions)



	1981	1982	1983	1984	1985
Reported Basis	353	257	283	283	**339**
Loan Loss Experience Basis	318	141	185	289	**391**

Relative Contribution of Bank of Montreal (Parent Bank) and Harris Bankcorp, Inc. (Harris)

The acquisition of Harris on September 4, 1984 significantly impacted the assets and earnings of Bank of Montreal.

Although all Harris assets were combined with those of the Parent Bank at the end of fiscal 1984, only that part of Harris income earned in the period from September 4, 1984 to October 31, 1984 was included. This impacts any comparison of 1984 and 1985 consolidated net income.

In the table below, the first two columns show the summary income statement, average assets and resultant ratios for the Parent Bank and separately for Harris for 1985, on a loan loss experience basis. The third column shows the adjustments required to reconcile to the reported results on a consolidated basis, shown in the final column. The major component of the combination adjustments is net interest income which reflects the imputed cost of funding the investment in Harris.

Notionally, the Harris acquisition is to be funded with additional equity capital over and above that required in the operations of the Parent Bank. Because of the size of the acquisition, it was impractical to achieve this immediately. To the extent that the funds invested in Harris have not been covered by equity capital, a balance remains to which an interest cost is attributed in determining the relative contributions to net income. For 1985, on average, 56% of the cost of the Harris acquisition was deemed to have been funded by additional equity capital and 44% by interest bearing funds. The interest cost imputed to the latter, with related tax adjustments, is set off against the earnings flow from Harris in determining its net contribution to the consolidated earnings of the Bank. As the equity component increases, which it is expected to do, the interest expense imputed to the funding of the Harris acquisition will decrease and, in due course, vanish. At this point, the value of the Harris acquisition will be a reflection of its earning power.

The remaining components of the combination adjustments reflect the amortization of the amount by which the purchase price of the Harris acquisition exceeded its net asset value.

Loan Loss Experience Basis 1985	Parent Bank	Harris	Combination Adjustments	Bank of Montreal Consolidated
Income ($ millions)				
Net Interest Income*	1,799.6	379.2	(38.8)	2,140.0
Loan Loss Experience	290.1	39.5	–	329.6
	1,509.5	339.7	(38.8)	1,810.4
Other Operating Income	469.2	211.4	1.4	682.0
Non-Interest Expense	1,373.5	395.3	18.6	1,787.4
	605.2	155.8	(56.0)	705.0
Provision for Income Taxes*	254.5	80.4	(24.9)	310.0
Minority Interest	4.4	–	–	4.4
Net Income	346.3	75.4	(31.1)	390.6
Average Assets ($ billions)	67.6	11.7	0.2	79.5
Return on Average Assets (%)	0.51	0.64		0.49

*Tax equivalent basis

Harris 1985 vs 1984

As noted earlier, only that part of Harris income earned in the period from September 4, 1984 to October 31, 1984 is included in the consolidated income for 1984. The table below compares Harris 1985 results to the preceding twelve months in order to show the results for a comparable period.

Harris' net income in 1985 was U.S. $18.7 million or 52% above the previous year. Growth in net income in 1985 was primarily a function of greater net interest income, along with strong performances in bond trading, foreign exchange activities, and fees from banking services.

Contributing to the improved net interest income were wider market spreads, a richer mix of assets (lower-yielding deposits with banks and money market assets were allowed to run off and were replaced by higher-yielding loans), and an increase in the proportion of free to interest bearing funding (increased equity and demand deposits).

The high income growth, coupled with a stable level of average assets, resulted in a significant increase in return on average assets from 0.41% to 0.63%.

In August 1985, Harris acquired the First National Bank and Trust Company of Barrington, a Chicago suburban bank with assets of approximately U.S. $350 million.

Harris 12 Months Ended October 31,	1984	1985
Income (U.S. $ millions)		
Net Interest Income*	230.1	287.4
Loan Loss Experience	18.9	29.2
	211.2	258.2
Other Operating Income	121.4	147.7
Non-Interest Expense	267.4	293.0
	65.2	112.9
Provision for Income Taxes*	29.3	58.3
Net Income	35.9**	54.6***
Average Assets (U.S. $ billions)	8.8	8.7
Return on Average Assets (%)	0.41	0.63***

*Tax equivalent basis

**Includes U.S. $3.7 million in respect of an adjustment of income of prior periods for a change in the method of accounting for investment tax credits.

***Converting to Canadian dollars and Canadian accounting principles, the 1985 Net Income for Harris was Cdn. $75.4 million and the Return on Average Assets 64 basis points.

Net Interest Income and Spread

Net interest income is the difference between interest earned on loans and securities and interest paid on deposits and debentures. For the purpose of analysis it is adjusted to a tax equivalent basis, as described in the Introduction.

Net interest spread is the net interest income adjusted to a taxable equivalent basis divided by the average of month-end total assets.

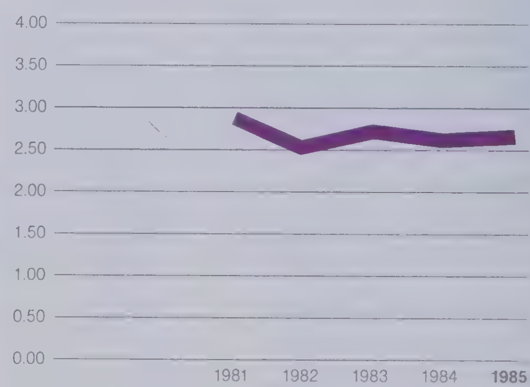
The Bank's consolidated tax equivalent net interest income in 1985 amounted to $2,140 million; an increase of $387 million from the previous year.

Dealing first with the Parent Bank, the improvement in spread from 2.63% in 1984 to 2.66% in 1985 was caused by two main factors.

On the positive side, a generally favourable interest rate environment throughout the year enabled the Bank to achieve higher spreads on International Money Market Operations. On the negative side, the margin between the Canadian prime rate and the average cost of deposits has narrowed. This is primarily because Canadian personal banking customers are shifting their deposit balances into accounts which offer a higher interest yield.

Harris has experienced a significant improvement in net interest spread which increased from 2.69% last year to 3.25% in 1985. This was achieved through an improvement in asset mix with an increasing proportion of higher yielding assets such as consumer and commercial loans. In addition, the cost of funding improved with new equity and higher demand deposits increasing the proportion of interest free funds.

Net Interest Spread—Tax Equivalent Basis
(As a % of average assets)



Net Interest Income (N.I.I)
Tax Equivalent Basis
($ in millions)

	1981	1982	1983	1984	1985
Total Bank N.I.I. as Reported	1,358	1,370	1,582	1,626	**1,965**
Taxable Equivalent Adjustment	222	220	155	127	**175**
N.I.I. on Tax Equivalent Basis	1,580	1,590	1,737	1,753	**2,140**
(As a % of average assets)					
Parent Bank	2.88	2.54	2.73	2.63	**2.66**
Harris				2.69*	**3.25**
Total Bank	2.88	2.54	2.73	2.63*	**2.69**

*The ratio for Harris has been restated to reflect net interest income for the full year However, the Total Bank ratio reflects the consolidated net interest income which includes only two months for Harris

Loan Loss Experience and Provision for Loan Losses

Loan Loss Experience

The Bank's consolidated loan loss experience in 1985 amounted to $330 million, a decrease of $35 million from 1984. For the Parent Bank however, loan loss experience for the year was $290 million, a decrease of $73 million or 20% from 1984. Over the last two years the Parent Bank has reduced its loan loss experience by $260 million, despite having set aside significant general reservations in that period.

The continuing decline in loan loss experience is the result of a combination of factors. The Bank benefited from improvements in all aspects of its lending and collection functions. The world economy has also improved from the depressed years of 1981 and 1982 reducing losses both in Canada and internationally.

The Bank's consolidated ratio of loan loss experience to eligible loans in 1985 was 58 basis points, down 10 basis points from 1984, and 61 basis points lower than 1983.

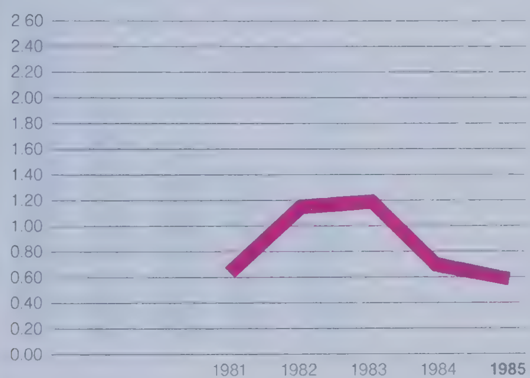
Provision for Loan Losses

The provision for loan losses is determined pursuant to a formula prescribed by the Minister of Finance. It is designed to average the loan loss experience over five years. Thus the impact on net income of changes in loan loss experience is delayed. Therefore, despite the continued decline in loan loss experience since 1983, the Bank's provision for loan losses has increased in 1985.

In 1984 the Bank's consolidated loan loss experience was $10 million less than the provision for loan losses. In 1985, as shown in the table and graph, that gap has widened to $98 million.

Another factor in the calculation of the provision is the total of eligible loans at September 30th each year. On that date in 1985 the Bank's total of eligible loans had reached $57 billion, an increase of $3 billion from 1984.

Loan Loss Experience
(As a % of eligible loans)



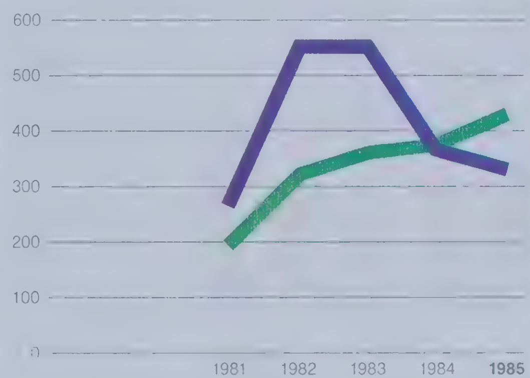
	1981	1982	1983	1984	1985
Parent Bank	0.61	1.13	1.19	0.77	**0.59**
Harris				0.34*	**0.51**
Total Bank	0.61	1.13	1.19	0.68*	**0.58**

Eligible Loans
($ in millions)

	1981	1982	1983	1984	1985
Parent Bank	44,576	48,598	46,160	46,772	**49,154**
Harris				7,229	**7,827**
Total Bank	44,576	48,598	46,160	54,001	**56,981**

*The ratio for Harris has been restated to reflect loss experience for the full year. However, the Total Bank ratio reflects the consolidated loan loss experience which includes only two months for Harris.

Loan Loss Experience & Provision for Loan Losses
($ in millions)



	1981	1982	1983	1984	1985
Loan Loss Experience	268	550	551	365	**330**
Provision for Loan Losses	196	319	361	375	**428**

Other Operating Income

Other operating income consists of service charges, charge card income, most loan administration fees, income from foreign exchange, trust income and all other income which is not dividend or interest income.

In 1985 such income on a consolidated basis was $682 million, an increase of $183 million from last year.

The inclusion of Harris results for a full year accounts for $186 million of the increase. While the Parent Bank's other revenue decreased by $3 million from the previous year, 1984 results included approximately $43 million of non-recurring gains.

Income from service charges rose 25% from 1984. The increase in service charge income for the Parent Bank was 5% which arises from both increases in the volume of transactions and selective price increases.

Charge card income increased by 67%. The Parent Bank increase was 12% with the remainder relating to Harris, now included for the full year. The bulk of charge card income is derived from merchant fees and these have increased due to a higher volume of charge card transactions. Fees also increased from the issue of the new gold MasterCard early in the fiscal year.

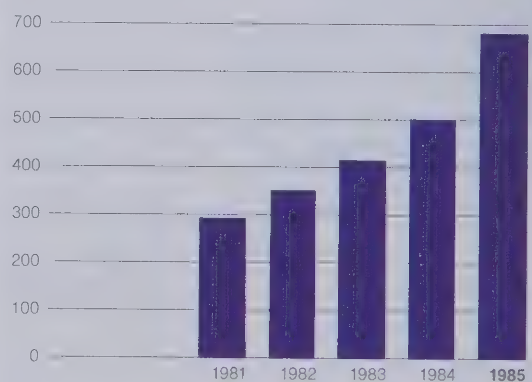
Loan administration fees increased by 31%. The Parent Bank increase was 12% with Harris accounting for the remainder.

Growth in foreign exchange revenues was strong in both the Parent Bank and Harris. The Parent Bank achieved an increase of almost 30% to $65 million in 1985.

Trust income, a major activity for Harris, was $85 million in 1985, up $10 million over the previous year. Shown in the table for 1984 is income of $14 million for the two months since the acquisition in 1984.

The category of "Other" contains such items as safe-keeping fees and commissions. This category increased by $12 million predominantly due to Harris.

Other Operating Income
($ in millions)



	1981	1982	1983	1984	1985
Service charges	87	109	128	148	**185**
Charge cards	58	65	66	78	**130**
Loan fees	59	77	93	87	**114**
Foreign exchange	43	34	46	50	**77**
Trust Income	–	–	–	14	**85**
Non-recurring gains	–	–	–	43	**–**
Other	46	66	78	79	**91**
■ Total Bank	293	351	411	499	**682**

Other Operating Income
(As a % of average assets)

	1981	1982	1983	1984	1985
Parent Bank	0.53	0.56	0.65	0.73	**0.69**
Harris				1.42*	**1.80**
Total Bank	0.53	0.56	0.65	0.75*	**0.86**

*The ratio for Harris has been restated to reflect other operating income for the full year. However, the Total Bank ratio reflects the consolidated other operating income which includes only two months for Harris.

Non-Interest Expense

Non-interest expense consists of employee costs, premises and equipment costs and all other operating expenses.

In total these expenses amounted to $1,787 million in 1985, an increase of $403 million from last year. Harris and the combination adjustments account for $354 million of this increase with non-interest expenses this year of $414 million compared to $60 million for the two months included in 1984. Thus, the operating expenses of the Parent Bank have increased by $49 million or 3.7% which compares to an average rate of growth in the three preceding years of approximately 10%.

Employee expenses at $996 million were $219 million higher than last year of which Harris accounts for $186 million. The Parent Bank increased by $33 million or 4%, attributable primarily to salary increases during the year.

Premises and equipment costs increased from $213 million in 1984 to $261 million in 1985. The impact of the inclusion of Harris for twelve rather than two months, accounts for $35 million of this increase. For the Parent Bank, premises and equipment costs have increased by $13 million or 7%.

Computer expenses as shown in the table comprise principally depreciation and rental of computer equipment and the cost of data communication. At $104 million such costs have increased by $29 million, all but $2 million being due to the inclusion of Harris. These expenses do not reflect all technology-related expenses of the Bank, some of which are included in salaries and in premises and equipment, as applicable.

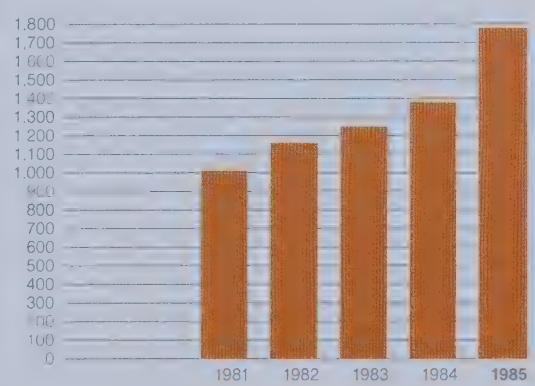
The category of "Other expenses" contains such items as travel, advertising, communications and provincial capital taxes. This category has increased by $107 million, all of which is attributable to the inclusion of Harris and the combination adjustments. Thus, for the Parent Bank, other expenses have remained unchanged from last year.

Capital taxes however, remain a significant cost which has continued to increase steadily over the past five years and reached approximately $19 million in 1985.

Harris has a higher ratio of expenses to assets compared to the Parent Bank. This is often the case for U.S. banks, and reflects a greater emphasis on activities that do not have a balance sheet impact, but generate non-interest income. In the case of Harris, their widespread trust activities represent such an item.

Because of the much higher expense ratio of Harris and the inclusion of Harris results for a full year, the Bank's consolidated ratio of non-interest expense to average assets increased in 1985 to 2.25% from 2.07% in 1984. For the Parent Bank however, that ratio remains unchanged at 2.03% in 1985.

Non-Interest Expense
($ in millions)



	1981	1982	1983	1984	1985
Salaries and staff benefits	603	694	727	777	**996**
Premises and equipment	137	149	183	213	**261**
Computer	48	72	74	75	**104**
Other expenses	218	248	265	319	**426**
■ Total Bank	1,006	1,163	1,249	1,384	**1,787**

Non-Interest Expense
(As a % of average assets)

	1981	1982	1983	1984	1985
Parent Bank	1.83	1.85	1.96	2.03	**2.03**
Harris				3.13*	**3.36**
Total Bank	1.83	1.85	1.96	2.07*	**2.25****

*The ratio for Harris has been restated to reflect non-interest expense for the full year. However the Total Bank ratio reflects the consolidated non-interest expense which includes only two months for Harris.

**The Total Bank expense ratio for 1985 has increased because of the inclusion of Harris results for the full year in 1985 compared to only two months in 1984.

Income and Capital Taxes

In 1985 the Bank's provision for income taxes was $88 million, an increase of $9 million from 1984. Expressed as a percentage of income before taxes the provision was 20.3% in 1985, as compared with 21.5% in 1984.

This rate is less than the Canadian statutory marginal income tax rate of 48.1% applicable in 1985. This difference is primarily attributable to the income derived by the Bank from tax-exempt instruments. In substance, the benefit to the Bank arising from the non-taxable status of such income is passed on to the issuers of these instruments in the form of reduced borrowing costs. The yield on these instruments is approximately one-half of that which would prevail on taxable obligations.

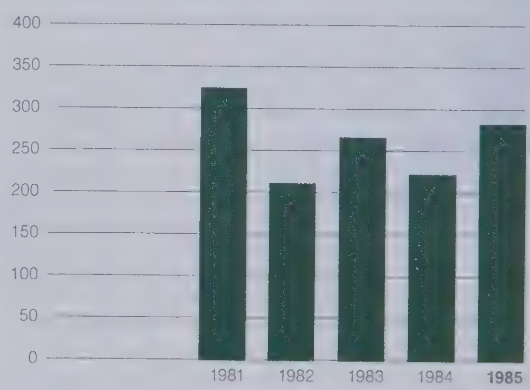
As previously explained, the taxable equivalent adjustment increases both net interest income and provision for income taxes to the amounts which would result if the income from these instruments were taxable. Restated on this basis, the provision for income taxes would amount to 43% of income before taxes in 1985.

The aggregate tax rate is also impacted by the rates of foreign tax applicable to the income earned by foreign subsidiaries of the Bank. The combined effective tax rate on these earnings is lower than the Canadian statutory marginal income tax rate. The fact that part of the Bank's income is taxed at a lower rate has the effect of lowering the overall tax rate.

Another element of taxation which is not included in the provision for income taxes is provincial capital taxes which are treated as other non-interest expenses. In 1985, the amount of these taxes payable by the Bank was $19 million.

In addition to direct taxes on income and capital, Canadian chartered banks, unlike trust companies or other financial institutions with which the Bank competes, are required under the Bank Act to deposit interest free reserves with the Bank of Canada. The foregone interest on these reserves represents a significant cost to the Bank.

Income and Capital Taxes – Tax Equivalent Basis
($ in millions)



	1981	1982	1983	1984	1985
Provision (recovery) for income taxes	92	(22)	96	79	**88**
Taxable equivalent adjustment	222	220	155	127	**175**
Capital Taxes	12	13	15	17	**19**
■ Income and Capital Taxes on Tax Equivalent Basis	326	211	266	223	**282**

Average Assets

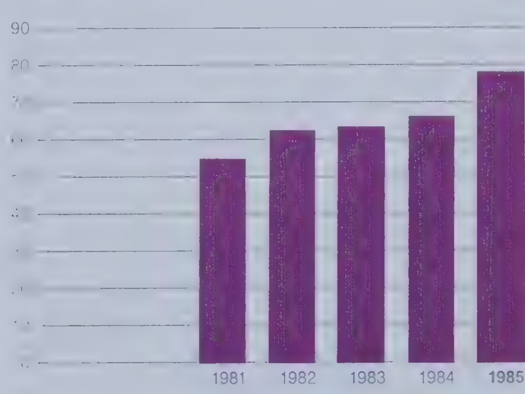
Average assets, defined as the average of the month-end assets of the Bank, increased $12.8 billion or 19.1% to $79.5 billion in 1985. This increase is largely attributable to the inclusion of Harris which accounts for $10 billion. Excluding Harris, the Parent Bank's average assets have increased by 4.3%.

Loan growth for the Parent Bank in 1985 was approximately $1.7 billion or 4.0%. In Canada, mortgage loan volumes increased, helped by several new products introduced in 1985. Personal loans also showed good growth. Outside Canada, loan growth in the latter months of the year compensated for a decline in the first half of 1985.

For the Total Bank, the level of liquid assets increased to $19.3 billion by the end of the year, some $1.0 billion higher than at the end of last year with the increase primarily centered in Treasury Bills. Liquid assets are those assets that are readily encashable and consist of both cash resources including deposits with banks and liquid securities including Treasury Bills of the Government of Canada.

The historically high level of liquidity arises from continued strong deposit growth.

Average Assets
($ in billions)



	1981	1982	1983	1984	1985
Parent Bank	55.0	62.8	63.7	65.0	**67.8**
Harris				10.9*	**11.7**
Total Bank	55.0	62.8	63.7	66.7*	**79.5**

*The average assets for Harris have been restated to reflect those for the full year. For the period from September 4, 1984 to October 31, 1984 the average assets were $1.7 billion which is reflected in the average assets of the Total Bank.

Non-Performing Loans Net of Reservations for Losses

Non-performing loans, as defined by the Inspector General of Banks, are those loans and loan substitution securities which have been placed on a non-accrual basis under circumstances outlined in the section of this report entitled "Significant Accounting Policies and Practices" and those loans which have been renegotiated at a reduced interest rate.

In 1985, the definition of non-performing loans was amended by the Inspector General of Banks and the information for 1984 as shown in the table has been restated to be on a consistent basis.

Loan loss reservations comprise specific and general reservations set aside against the possibility that loan principal will not be repaid.

During 1985 the Bank has continued to set aside specific reservations against individual loans where collectibility remains in doubt and both specific and general reservations against sovereign debt.

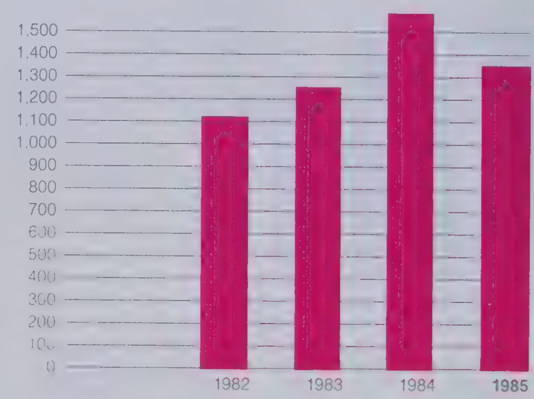
The Inspector General of Banks requires that, by October 1986, all Canadian banks set aside reservations against balances outstanding to 32 specified countries. At October 31, 1985, the Bank had set aside general and specific reservations amounting to 10% of all public, private and interbank indebtedness at risk in those countries.

In aggregate, general and specific reservations have increased by $200 million to $1,302 million by the end of 1985.

At October 31, 1985 the Bank's non-performing loans net of reservations amounted to $1,337 million, a decrease of $256 million from the end of fiscal 1984. They now represent 2.35% of total eligible loans compared to 2.95% last year.

The Bank's yield net of interest reversals on net non-performing loans in 1985 was 9.5% against 7.5% in 1984, restated on a comparable basis.

Non-Performing Loans at Year End Net of Reservations For Losses
($ in millions)



	1982	1983	1984	1985
Non-performing loans ($ in millions)	1,124	1,262	1,593*	**1,337**
Eligible Loans ($ in millions)	48,598	46,160	54,001	**56,981**
Non-performing loans As a % of Eligible Loans	2.31	2.73	2.95*	**2.35**
Interest Income on Non-Performing Loans ($ in millions)	25	114	122	**127**

*Restated to be on the same basis as 1985

Capital Funds

The capital and contingency reserves shown on the Statement of Assets and Liabilities comprise funds invested by shareholders, retained earnings and appropriations for contingencies. Reservations for loan losses are not included in either capital or contingency reserves.

At the end of the fiscal year, total capital and contingency reserves were $3.5 billion, an increase of $507 million from a year ago. Capital funds were $4.6 billion at October 31, 1985, $541 million higher than the previous year-end.

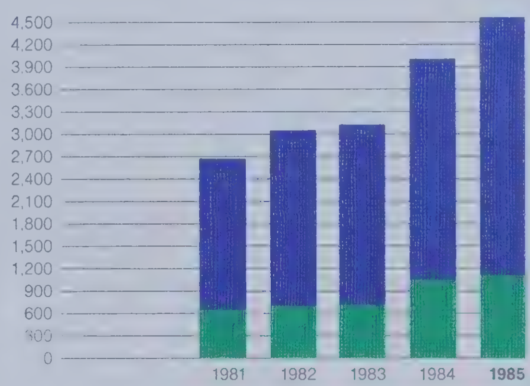
The expansion of the Bank's capital base in 1985 came primarily from retained earnings, proceeds from shareholder reinvestment plans, and the amount by which charges to income in respect of loan losses exceeded the actual loan loss experience for the year.

The Bank's ratio of equity capital and contingency reserves to total assets was 4.19% at October 31, 1985, an increase of 34 basis points from 1984.

In the United States, the regulatory definition of capital permits the inclusion of provisions for credit losses whereas in Canada, the equivalent, loan loss reservations, are entirely excluded. Because the Bank has $1.3 billion set aside as loan loss reservations, this difference in methodology results in a lower capital ratio calculated in accordance with Canadian practice than would be the case in the United States.

During the last five years the Bank's capital and contingency reserves have been increased through various shareholder plans, the retention of earnings and a limited number of new issues. These increases have enabled the Bank to increase the ratio of capital and contingency reserves to total assets despite the 32% increase in assets during the same period.

Capital Funds
($ in millions)



	1981	1982	1983	1984	1985
Bank Debentures	654	726	728	1,065	**1,100**
Equity Capital	2,029	2,316	2,388	2,946	**3,452**
Total Capital Funds	2,683	3,042	3,116	4,011	**4,552**
Capital Ratios (Percentage)					
Ratio of total capital and contingency reserves to total assets (%)	3.25	3.73	3.78	3.85	**4.19**
Ratio of total capital and contingency reserves and subordinated debt to total assets (%)	4.30	4.90	4.93	5.24	**5.52**

Return on Average Assets

One of the most commonly used measures of bank performance is the return on average assets which is defined as net income divided by the average of month-end total assets.

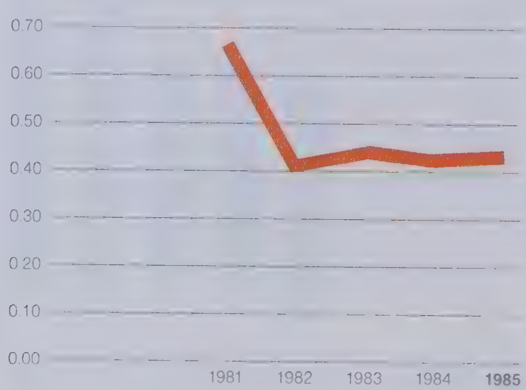
In 1985 the Bank reported a return on average assets of 0.43%, 1 basis point higher than the previous year.

On a loan loss experience basis, the return on average assets was 49 basis points, an increase of 6 basis points from last year. The Parent Bank return rises to 51 basis points, up 8 basis points from the previous year.

As explained in the section dealing with the relative contribution of the Parent Bank and Harris, the combined return is less than the return of either Harris or the Parent Bank because the consolidated bank bears the cost of funding the investment in Harris.

Looking at the return over the last five years on a loan loss experience basis, a substantial improvement can clearly be seen as can the effects of the significant loan losses that were suffered in 1982 and 1983.

Return on Average Assets
Reported Basis (%)



	1981	1982	1983	1984	1985
Total Bank	0.64	0.41	0.44	0.42	**0.43**

Return on Average Assets
Loan Loss Experience Basis (%)

	1981	1982	1983	1984	1985
Parent Bank	0.58	0.22	0.29	0.43	**0.51**
Harris				0.41*	**0.64**
Total Bank	0.58	0.22	0.29	0.43*	**0.49**

*The ratio for Harris has been restated to reflect net income for the full year. However, the Total Bank ratio reflects the consolidated net income which includes only two months for Harris.

Domestic/International Segmented Financial Data

The table below shows the income, average assets and return on average assets for the Bank segmented between Domestic and International Operations.

For the purpose of this analysis, Domestic Operations represents the Bank's business booked in Canada as transacted in a variety of currencies regardless of the residency of the customer. International Operations represents business booked outside of Canada, again regardless of currency or residency of the customer.

However, transactions on international money markets are deemed to be international even if booked in Canada.

In order to segment Domestic and International results, it is necessary to make certain allocations. The capital funds of the Bank are allocated based upon relative average assets. Any remaining excess or shortfall of assets in comparison with liabilities and capital funds is considered as supplied to or funded by the other segment at the marginal cost of funds. Corporate expenses are allocated based upon the relative amounts of non-interest expenses of each segment.

In order to provide comparability of the data with industry practice, certain of these allocations were revised in 1985 and the 1984 figures have been restated accordingly. These revisions do not have a material effect on prior years' segmented earnings.

On a loan loss experience basis both Domestic and International Operations showed improvement in 1985 over 1984.

Domestic Operations shows a 5 basis point improvement with the most significant contributor the decline in loan loss experience. The fall in net interest income, caused mainly by the increasing cost of deposits relative to prime, was offset by improvements in other operating income.

Average international assets have increased by $12.8 billion, of which $10 billion relates to Harris with the remaining increase mainly attributable to the effects of currency translation.

The increased net income from International Operations had three major causes. First the inclusion of Harris results for the full year, secondly the improved spreads on International Money Market Operations and thirdly, higher yields on foreign non-performing loans.

	Domestic		International		Total Bank	
Loan Loss Experience Basis	1984	1985	1984	1985	1984	1985
Net Income ($ Millions)						
Net Interest Income	1,208.8	1,190.4	417.6	774.7	1,626.4	1,965.1
Loan Loss Experience	232.0	164.0	133.0	165.7	365.0	329.7
	976.8	1,026.4	284.6	609.0	1,261.4	1,635.4
Other Operating Income	412.3	431.1	87.0	250.9	499.3	682.0
Non-Interest Expense	1,190.6	1,216.1	193.6	571.3	1,384.2	1,787.4
	198.5	241.4	178.0	288.6	376.5	530.0
Provision for Income Taxes	32.6	56.0	50.8	79.0	83.4	135.0
Minority Interest	4.4	4.4	0.0	0.0	4.4	4.4
Net Income	161.5	181.0	127.2	209.6	288.7	390.6
Average Assets ($ Billions)	40.5	40.5	26.2	39.0	66.7	79.5
Return on Average Assets (%)	0.40	0.45	0.49	0.54	0.43	0.49

Investor Information

Capital Stock
At October 31, 1985, the Bank had four types of shares outstanding: Convertible Class A Preferred Shares Series 1, Class A Preferred Shares Series 2, Class A Preferred Shares Series 3, and common shares. The Class A Preferred Shares Series 1 pay cumulative preferred dividends at an annual rate of $2.85 per share and are convertible at the option of the holder at any time prior to May 26, 1991 on a one-for-one basis (subject to adjustment for certain events). The Class A Preferred Shares Series 2 pay cumulative preferred dividends at an annual rate of $2.50 per share and entitle holders of record on June 14, 1985 to receive one common share purchase warrant entitling them to purchase one common share at $33.00 from June 17, 1985 to December 15, 1988. The Class A Preferred Shares Series 3 pay cumulative preferred dividends at an annual rate of $2.125 until February 23, 1989, thereafter, the quarterly dividend shall be the greater of $0.53125 per share or an amount determined by applying one quarter of 75% of the Bank's average Prime Rate for stated periods to $25.

Listing of Stock
The common shares of the Bank are listed on the Montreal, Toronto, Winnipeg, Alberta and Vancouver stock exchanges in Canada and The Stock Exchange, London, England. The shares list under the following stock symbols on Canadian exchanges: "BMO" for the common stock, "BMOU" for the Convertible Class A Preferred Shares Series 1, "BMOX" for the Class A Preferred Shares Series 2, and "BMOC" for the Class A Preferred Shares Series 3.

Stock Prices
The following table sets forth the high and low closing sale prices on the Toronto Stock Exchange of the common shares of the Bank for the periods indicated:

Year	High	Low	Volume
1981	$33.375	$23.500	7,198,981
1982	26.750	17.000	10,990,400
1983	33.625	24.750	12,373,774
1984	28.375	21.375	16,740,700
1985 Jan. 1-Oct. 31	31.50	25.125	16,424,287

Transfer Agent and Registrar
The principal transfer agent for both the common and preferred shares of the Bank is The Royal Trust Company at its principal offices in Halifax, Montreal, Toronto, Winnipeg, Regina, Calgary and Vancouver. The Royal Trust Company also acts as registrar for these shares.

Dividends
Dividends paid on the common shares of the Bank over the past five years are shown in the following table:

	Year ended October 31				
	1981	1982	1983	1984	**1985**
Dividends paid per common share	$1.72	$1.95	$1.96	$1.96	**$1.96**

Dividend Options
Shareholders of Bank of Montreal may choose from several dividend options including:

Shareholder Dividend Reinvestment and Share Purchase Plan
Stock Dividend Program
Electronic Funds Transfer Service

Shareholder Dividend Reinvestment and Share Purchase Plan

The Shareholder Dividend Reinvestment and Share Purchase Plan provides a means for holders of record of common shares or Class A Preferred Shares Series 1, Series 2 or Series 3, resident in Canada, to reinvest cash dividends in new common shares of the Bank at a purchase price of 95% of the average market price, without the payment of any commissions or service charges. Shareholders may also purchase additional common shares of the Bank at 100% of the average market price by making optional cash payments of up to $40,000 per annum, whether or not dividends on shares are being reinvested.

Stock Dividend Program

The Stock Dividend Program provides a means for holders of record of at least 100 common shares or 100 Class A Preferred Shares Series 1, Series 2 or Series 3 to acquire common shares of the Bank at 95% of the average market price by electing that dividends be paid by the issue of common shares of the Bank having a value substantially equivalent to the cash dividend otherwise payable.

Electronic Funds Transfer Service

Shareholders not wishing to participate in the Shareholder Dividend Reinvestment and Share Purchase Plan or the Stock Dividend Program may choose to have dividends deposited directly to an account in any financial institution which provides electronic funds transfer facilities.

Details of the dividend options and enrolment forms may be obtained by contacting The Royal Trust Company, Corporate Trust Division, 630 Dorchester Boulevard West, Montreal, Quebec H3B 1S6.

Restraints on Bank Shares Under the 1980 Bank Act

The Bank Act contains restrictions on the ownership of shares of the Bank. These restrictions limit ownership of shares by all non-residents to a maximum of 25% of any class of shares. These restrictions also do not allow any individual to own more than 10% of any class of shares and prohibit ownership of the Bank's shares by Canadian or foreign governments.

Distribution of Shareholders

The following table indicates the distribution of common shareholders by country of residence at October 31, 1985:

	Shareholders
Canada	98.3%
United States	0.7
Other	1.0
	100.0%

Copies of Annual Report

Additional copies of this Annual Report may be obtained by contacting the Bank's Public Affairs Department, P.O. Box 6002, Place d'Armes, Montreal, Quebec H2Y 3S8, or to Public Affairs, 1 First Canadian Place, Toronto, Ontario M5X 1A1; or to the divisional headquarters nearest you.

For other shareholder information, please write to the Secretary of the Bank, Head Office, P.O. Box 6002, Place d'Armes, Montreal, Quebec H2Y 3S8.

Directors of the Bank of Montreal

W.D. Mulholland, LL.D. ■▲
Chairman of the Board

Grant L. Reuber, Ph.D. ■•
President

William E. Bradford, F.C.G.A. ■
Deputy Chairman

Stanley M. Davison
Vice-Chairman

Jack H. Warren, O.C. △
Vice-Chairman

Charles F. Baird, LL.D. ■▲
Toronto
Chairman and
Chief Executive Officer
Inco Limited

Peter J.G. Bentley, O.C. △
Vancouver
Chairman and
Chief Executive Officer
Canfor Corporation

Claire P. Bertrand △
Montreal
Company Director

Robert A. Boyd, O.C. □
Montreal
Vice-President
Gendron Lefebvre Inc.

Charles R. Bronfman, O.C. □
Montreal
Deputy Chairman
Chairman, Executive Committee
The Seagram Company Ltd.

The Hon. Sidney L. Buckwold, LL.D. ■
Saskatoon
President
Buckwold's Ltd.

Fred S. Burbidge ■▲
Montreal
Chairman
Canadian Pacific Limited

Pierre Côté, C.M. □▲
Quebec
Chairman of the Board
Celanese Canada Inc.

H. Roy Crabtree, LL.D., D.C.L. ■
Montreal
President
The Harold Crabtree Foundations

C. William Daniel, O.C., LL.D. ■
Toronto
Corporate Director
and Consultant

Nathanael V. Davis, D.Sc. ■▲
Osterville, Mass.
Chairman
Alcan Aluminium Limited

Graham R. Dawson
Vancouver
President
G.R. Dawson Holdings Limited

Louis A. Desrochers, Q.C. ■▲
Edmonton
Partner
Messrs. McCuaig Desrochers

John H. Devlin △
Toronto
Company Director

A. John Ellis, O.C.
Vancouver
Chairman
Canadian Advisory Board
Marsh & McLennan Limited

Edmund B. Fitzgerald
Toronto
Chairman and
Chief Executive Officer
Northern Telecom Limited

John F. Fraser
Winnipeg
President and
Chief Executive Officer
Federal Industries Ltd.

Thomas M. Galt •
Toronto
Chairman and
Chief Executive Officer
Sun Life Assurance
Company of Canada

J. Peter Gordon, O.C., LL.D. ■▲
Toronto
Director
Stelco Inc.

John H. Hale
London, England
Managing Director
Pearson plc

Donald S. Harvie, O.C. △•
Calgary
Chairman
Devonian Foundation

Bruce I. Howe, LL.D.
Vancouver
President and
Chief Executive Officer
British Columbia Resources
Investment Corporation

Richard M. Ivey, Q.C., LL.D.
London, Ont.
Chairman of the Board
Allpak Limited

Betty Kennedy, O.C., LL.D. ■△
Toronto
Public Affairs Editor
CFRB Limited

Walther Leisler Kiep
Stuttgart
Federal Republic of Germany
Managing General Partner
Gradmann & Holler

Merv Leitch, Q.C.
Calgary
Partner
Macleod Dixon

The Right Hon. The Earl of Lindsay
London, England
Member, House of Lords

J. Blair MacAulay •
Toronto
Partner
Fraser & Beatty

Fred H. McNeil, LL.D. ■▲
Calgary
Chairman
Dome Canada Limited
Former Chairman and
Chief Executive Officer
Bank of Montreal

Ronald N. Mannix
Calgary
Chairman
Manalta Coal Ltd.

Jerry E.A. Nickerson
North Sydney, N.S.
Chairman
H.B. Nickerson & Sons Ltd.

Lucien G. Rolland, O.C., D.C.Sc. ■□
Montreal
Chairman and
Chief Executive Officer
Rolland inc.

William M. Sobey △
Stellarton, N.S.
Honorary Chairman
Sobeys Stores Limited

James C. Thackray ▲
Toronto
Director
Bell Canada

Lorne C. Webster □•
Montreal
Chairman and
Chief Executive Officer
Prenor Group Ltd.

B. Kenneth West
Chicago
Chairman of the Board and
Chief Executive Officer
Harris Bankcorp, Inc.

■ Member of the Executive Committee
W.D. Mulholland, Chairman

□ Member of the Audit Committee
H.R. Crabtree, Chairman

▲ Member of the Management Resources and Compensation Committee
J.P. Gordon, Chairman

△ Member of the Donations Committee
B. Kennedy, Chairman

• Member of the Pension Advisory Committee
G.L. Reuber, Chairman

Executive Officers

W.D. Mulholland
Chairman and Chief Executive Officer

G.L. Reuber
President and Chief Operating Officer

W.E. Bradford, F.C.G.A.
Deputy Chairman

S.M. Davison
Vice-Chairman

J.H. Warren
Vice-Chairman

K.O. Dorricott, F.C.A.
*Executive Vice-President and Chief Financial Officer**

W.B. Bateman
Executive Vice-President Corporate and Government Banking

G.E. Neal
Executive Vice-President and Treasurer

M.W. Barrett
Executive Vice-President Domestic Banking

K.E. Palmer
Executive Vice-President Commercial Banking (Canada)

G.W. Hopkins
Executive Vice-President Operations and Systems

Donald Munford
Executive Vice-President Credit Policy

Robert Muir
Vice-President and Secretary

Colin McGregor
Vice-President and Chief Accountant

Sohrab Zargham F.C.A. (U.K.)
*Vice-President and Chief Auditor**

*Effective January 1st, 1986

Legal deposit, 4th quarter (1985), Bibliothèque nationale du Québec. (On peut obtenir sur demande un exemplaire en français.)

For copies of the Annual Report, please write to the Public Affairs Department of the Bank, P.O. Box 6002, Place d'Armes, Montreal, Quebec H2Y 3S8, or to Public Affairs, 1 First Canadian Place, Toronto, Ontario M5X 1A1.

For other shareholder information, write to the Secretary of the Bank, P.O. Box 6002, Place d'Armes, Montreal, Quebec H2Y 3S8.

BANK OF MONTREAL